# An Asset Manager's Guide to Swap Trading in the New Regulatory World

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As a result of the Dodd-Frank Act, the over-the-counter derivatives markets have become subject to significant new regulatory oversight. As the markets respond to these new regulations, the menu of derivatives instruments available to asset managers, and the costs associated with those instruments, will change significantly. As the first new swap rules have come into effect in the past several months, market participants have started to identify risks and costs, as well as new opportunities, arising from this new regulatory landscape.

This memorandum is designed to provide asset managers with background information on key aspects of the swap regulatory regime that may impact their derivatives trading activities. The memorandum focuses largely on the regulations of the CFTC that apply to swaps, rather than on the rules of the SEC that will govern security-based swaps, as virtually none of the SEC's security-based swap rules have been adopted.

This memorandum first provides background information on the types of derivatives that are subject to the CFTC's swap regulatory regime, on new classifications of market participants created by the regime, and on the current approach to the cross-border application of swap requirements. For some asset managers, this background material will provide a framework by which to better understand how the swap regulatory regime will impact their derivatives activities. For those who are more familiar with this regime, we hope the background sections serve as a useful reference tool.

Following the background section, the memorandum discusses several key swap regulatory topics, highlighting practical considerations and potential opportunities for asset managers. We focus on near-term actions that asset managers should consider, which the timeline in Appendix A may help to put in context, and on the aspects of the regime that will most affect the costs and opportunities of asset managers' trading activities.

**Asset Manager To Do List:**

- assess trading risks and opportunities arising from publicly available swap price, volume and other transaction data;
- identify "active fund" clients and "third-party subaccount" clients to determine whether clearing for IRS and CDS must begin in March, June or September;
- negotiate clearing arrangements with primary and backup FCMs and choose clearinghouses in advance of clearing deadlines;
- start active dialogue with clients about new information and documentation that will be needed;
- adhere to ISDA Protocol 1.0 or negotiate a bilateral alternative with swap dealers by May 1;
- classify products traded as swaps, security-based swaps, mixed swaps or as outside the new derivatives regulatory regime;
- determine U.S. person status of clients and assess potential advantages of reorganizing trading structure; and
- collect information and calculate trading thresholds for MSP and CPO registration requirements.

# Swaps, Security-Based Swaps, Mixed Swaps and Excluded Instruments

The new Dodd-Frank Act swap regulatory regime applies to a wide range of derivatives instruments. Jurisdiction over these instruments is divided between the CFTC and the SEC.

- The CFTC has primary jurisdiction over **swaps,** the vast majority of the over-the-counter derivatives market. Swaps include interest rate swaps, foreign exchange derivatives (subject to the exclusion below) and commodity swaps, including swaps on physical commodities. Swaps also include credit default swaps and equity swaps (such as total return swaps) on broad-based security indices or swaps on more than one security or loan. Over-the-counter options, such as puts, calls, and other types of options that reference interest rates, foreign exchange and physical commodities are swaps. As noted below, however, options on securities or on an index of securities are excluded from the swap definition.
- The SEC has primary jurisdiction over **security-based swaps**, which generally include credit default swaps and equity swaps on a single security or a narrow-based index of securities or on a single loan.
- The CFTC and SEC have joint jurisdiction over **mixed swaps**, which are instruments that materially reference both swap and security-based swap underliers. The CFTC and SEC expect that the category of instruments classified as mixed swaps will be small in proportion to the size of the swaps and security-based swaps markets, and that it will primarily consist of instruments that reference both a commodity and a security, such as a “best-of” swap referencing the price of crude oil and the value of an oil company’s common stock. However, as discussed below, the classification of instruments that may be mixed swaps is often not as straightforward as for “best-of” swaps.

Many asset managers are familiar with the term “commodity interest,” which defines the scope of instruments that may cause a fund to be a commodity pool and triggers commodity pool operator or commodity trading advisor status. As reflected in the sidebar, the Dodd-Frank Act amended several provisions of the Commodity Exchange Act to include swaps within the definition of “commodity interest.”

Commodity interests include, among other instruments:

- futures and options on futures;
- security futures; and
- swaps, retail foreign exchange transactions and commodity transactions.

## Exclusions from Swaps Regulation

Some common derivatives are specifically excluded from the definitions of swap, security-based swap and mixed swap. These include, among others:

- spot transactions, including cash market transactions in foreign exchange, commodities and securities;
- futures and options on futures;

- options on a single security or group or index of securities; and
- physically settled forward transactions, including transactions in commodities and securities for deferred delivery.

**Foreign exchange forwards**

A "foreign exchange forward" is a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange.

**Foreign exchange swaps**

A "foreign exchange swap" is a transaction that solely involves:

- an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and
- a reverse exchange of those two currencies at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange.

**Spot foreign exchange transactions**

"Spot foreign exchange" transactions are defined as physical foreign exchange transactions that settle within T + 2 or within another timeline typical of the particular market, or settle contemporaneously with a securities transaction.

Deliverable **foreign exchange forwards** and deliverable **foreign exchange swaps**, as defined in the accompanying sidebar, are exempt from most, but not all, swap regulation. **Spot foreign exchange transactions**, as described in the sidebar, are not swaps and are exempt from swap regulation. Foreign exchange instruments that do not meet these definitions, including non-deliverable foreign exchange forwards (NDFs), currency and cross-currency swaps, foreign exchange options, so-called "rolling spot" transactions and contingent foreign exchange forwards are defined as swaps and subject to all swap requirements.

Increased regulation of swaps, security-based swaps and mixed swaps will have a significant effect on the availability, liquidity and pricing of even those instruments that are exempt from such regulation. As the costs, consequences and information transfer inherent in swap transactions change, asset managers will need to reassess their choices between standardized instruments and bespoke swaps. For example, based on demand from market participants, several exchanges have recently migrated some energy contracts, previously traded as swaps, to execution as futures contracts, a phenomenon known as "futurization."

Characterizing a particular instrument as a swap, security-based swap, mixed swap or an instrument that is exempt from swap regulation is a complicated matter and is the subject of a 585-page joint release from the CFTC and SEC. Unfortunately, these characterizations do not always follow the common names or economic characteristics of the instruments. For example, despite their name, so-called "rolling spot" foreign exchange transactions are not considered spot foreign exchange contracts exempt from swap regulation, but are considered non-deliverable swaps subject to the full set of CFTC swap requirements. Equity total return swaps with foreign exchange exposure will not always be mixed swaps; so-called "quanto" equity total return swaps are classified as security-based swaps while "compo" equity total return swaps are classified as mixed swaps. The difference between a physically settled forward transaction that is exempt from swap requirements and a commodity swap that is not exempt is based on the CFTC's historical Brent Interpretation and on a seven-part test, which looks to such concepts as "volumetric optionality."

We expect that regulatory guidance and market practice regarding the classification of these instruments will develop over time. However, asset managers should carefully assess the different types of derivatives instruments they trade. Classification is important for a wide variety of regulatory purposes—from determining the asset manager's registration obligations with the CFTC or SEC to assessing requirements for, and costs of, trading such instruments.

## Key Market Participants

### Swap Dealer

A "swap dealer" is defined as any person that:

- holds itself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
- engages in activity causing it to be commonly known in the trade as a dealer or market maker in swaps,

subject to a *de minimis* dealing activity threshold and other exceptions.

### Major Swap Participant

A "major swap participant" (MSP) is defined as any person that is not a swap dealer and:

- maintains a "substantial position" in one or more of the "major swap categories," excluding certain hedging positions in limited circumstances; or
- has outstanding swaps that create "substantial counterparty exposure" that could have serious adverse effects on the financial stability of the United States banking system or financial markets.

The CFTC and SEC have adopted rules further defining these registrant categories, including a quantitative test for major swap participant status.

In addition to mastering a new product vocabulary and categorizing trading instruments, asset managers should be aware of the new and expanded categories of regulated market participants created by the Dodd-Frank Act in order to be able to appropriately classify themselves, their clients and their counterparties and to understand the requirements that may be applicable as a result of their swap trading activities. In this section, we identify four new key swap market participant classifications—swap dealers, major swap participants (MSPs), end users, and special entities—and discuss how these classifications may include, or be particularly relevant to, asset managers and their clients.

### Swap Dealers

"**Swap dealers**," broadly defined to capture swap market makers, must register with the CFTC. Only those market participants that engage in more than specified *de minimis* levels of swap activity in a "dealing" capacity will qualify as swap dealers.

In defining the types of swap activities that constitute swap dealing, the CFTC specifically distinguishes between swap dealing and swap trading. Trading, as opposed to dealing, is evidenced by taking liquidity rather than providing it and taking prices rather than making them. Under this definition, asset managers and their clients typically would not be viewed as engaging in swap dealing activity and, as a result, will not usually be required to register as swap dealers.

Many, if not most, of an asset manager's usual swap counterparties will be swap dealers. In addition to registration with the CFTC, swap dealers are subject to a comprehensive swap regulatory regime, which affects all aspects of their swap dealing activities. These regulations are already significantly changing the manner in which swap dealers interact with their counterparties, including asset managers and their clients.

Asset managers should know which of their counterparties are registered swap dealers and which are not. For swap requirements that apply to all swaps regardless of the involvement of a swap dealer—such as swap data reporting (discussed below)—swap dealers are primarily responsible for compliance with those requirements. The obligations of an asset manager and its clients may increase, however, if their counterparty is not a registered swap dealer.

Many of the largest swap dealers were required to register with the CFTC through the National Futures Association (NFA) on or before December 31, 2012, and other swap dealers will need to register over time as they exceed the *de minimis* threshold of swaps activity. The NFA maintains a list of all registered swap dealers, which is available at **http://www.nfa.futures.org/NFA-swaps-information/SD-MSP-registry.html**. As of the date of this memorandum, there are 75 swap dealers registered with the CFTC.

## Major Swap Participants

Market participants that do not deal in swaps but that, by virtue of their swap positions, would pose significant potential risk to their counterparties and the U.S. financial system in the event of their default are required to register with the CFTC and will be subject to regulation that is generally similar to that of swap dealers. These "**major swap participants**" are identified using a complex quantitative test developed by the CFTC and SEC. In short, this test looks to the risk a market participant currently poses to its counterparties through uncollateralized out-of-the-money positions (known as "current uncollateralized exposure") and the potential risk the market participant may pose to its counterparties through a risk-adjusted swap notional calculation (known as "potential future exposure"). The quantitative tests require market participants to calculate their status at the end of each quarter, based on swap notional and exposure information from each business day of the quarter. Three safe harbors allow for less frequent and less complex calculations. We have prepared a presentation that provides a more detailed summary of the MSP test, which is available at **http://www.davispolk.com/files/uploads/MSPDefinition.pdf**. The CFTC expects only a handful of market participants to exceed the high thresholds in the MSP test and to register as MSPs.

Since the MSP tests include swaps entered into in an investment capacity, and not only those entered into in a dealing capacity, the tests are directly relevant to asset managers and their clients. Asset managers that do not engage in high levels of proprietary swap trading are unlikely to be MSPs as the test does not attribute a client's swap positions to its asset manager and does not require the aggregation of positions across clients. However, an asset manager's clients, as the direct counterparties to swaps arranged by the asset manager, may qualify as MSPs. Asset managers should evaluate their and their clients' businesses to assess whether they may need to conduct the detailed calculations necessary to determine if their clients' positions exceed the MSP registration thresholds or if they meet the terms of one of three safe harbors from MSP status.

The MSP test raises particular issues in the context of separately managed accounts. To the extent that a swap counterparty to a separately managed account has recourse to the beneficial owner of the separate account, the swap positions held in the separate account must be included in the account owners' MSP calculations. Asset managers should consider educating their separately managed account clients about the MSP tests and may be called upon to provide those clients with regular calculations of the "current uncollateralized exposure" and "potential future exposure" of the positions managed for the client. In addition, since significant regulatory obligations apply to MSPs, asset managers will need to know whether their separately managed account clients are MSPs, regardless of whether the asset manager trades for the client on a limited recourse basis. Asset managers should engage in outreach efforts to their separate large account clients that might plausibly be MSPs to determine whether those clients have evaluated their own MSP status and to assist them with those evaluations as needed.

The first MSPs were required to register with the CFTC through the NFA on February 28, 2013. The NFA's registry (available at **http://www.nfa.futures.org/NFA-swaps-information/SD-MSP-registry.html**) includes a list of all registered MSPs. As of the date of this memorandum, there are 2 registered MSPs. The significantly small number of registered MSPs reflects the very high numerical thresholds for MSP registration.

**Financial Entity**

A "financial entity" is defined as any person that is:

- a swap dealer or security-based swap dealer;
- a major swap participant or a major security-based swap participant;
- a commodity pool;
- a private fund;
- an ERISA plan; or
- a person predominantly engaged in the business of banking, or in activities that are financial in nature (as defined).

## End Users: Financial Entities and Commercial End Users

Swap market participants that are neither swap dealers nor MSPs are colloquially referred to as "**end users**." Most asset managers and their clients will fit into this category.

For the purpose of some rules, end users are divided into financial end users—those that are **financial entities**—and **commercial end users**—those that are not financial entities. Financial entities, as defined in the sidebar, are treated differently from commercial end users under some swap rules, such as margin and the phase-in rules for clearing, as discussed below.

End users are subject to far fewer regulatory burdens than swap dealers or MSPs. End users, however, will be directly subject to some swap regulatory requirements and will be significantly affected, although indirectly, by requirements imposed on their swap dealer counterparties.

**Special Entity**

A "special entity" is defined as:

- a federal agency;
- a state, state agency, city, county, municipality, other political subdivision of a state, or any instrumentality, department, or a corporation of or established by a state or political subdivision of a state;
- any employee benefit plan subject to Title I of ERISA;
- any governmental plan, as defined in Section 3 of ERISA;
- an endowment; or
- an employee benefit plan defined in Section 3 of ERISA that elects to be a Special Entity.

## Special Entities

**Special entities**, as defined in the sidebar, are afforded additional protections under the swap rules in the form of heightened obligations owed to them by swap dealers and MSPs. These heightened obligations may have the effect of increasing the cost of swaps for special entities or making swap dealers less willing to trade with them. Special Entities will be asked by their swap dealer and MSP counterparties to enter into new forms of documentation that relate to this requirement.

In addition, an asset manager may need to be identified by swap dealer or MSP counterparties as a fiduciary for a client that is a special entity by virtue of being an employee benefit plan subject to Title I of ERISA (an ERISA special entity) and may need to represent that it serves as a "qualified independent representative" to a non-ERISA special entity client. The additional requirements on swap dealers or MSPs that are relevant to special entities are described in greater detail below.

**Exemptive Order Definition of "U.S. Person"**

A "U.S. person" includes:

i. A natural person who is a resident of the United States;

ii. A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing, in each case that is:

  a. organized or incorporated under the laws of a state or other jurisdiction in the United States; or

  b. effective as of April 1, 2013 for all such entities other than funds or collective investment vehicles, having its principal place of business in the United States;

iii. A pension plan for the employees, officers or principals of a legal entity described in (ii) above, unless the pension plan is primarily for foreign employees of such entity;

iv. An estate of a decedent who was a resident of the United States at the time of death, or a trust governed by the laws of a state or other jurisdiction in the United States if a court within the United States is able to exercise primary supervision over the administration of the trust; or

v. An individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described above.

Any person not listed in (i) to (v) above is a "non-U.S. person" for purposes of the Exemptive Order.

# Cross-Border Application of the U.S. Swap Regulatory Regime

The U.S. swap regulatory regime applies to any swap between **U.S. persons** and generally does not apply to a swap between two non-U.S. persons that have no nexus to the United States. The applicability of U.S. swap regulations to situations that fall between these two extremes is unsettled and less clear. This "cross-border" or "extraterritoriality" issue is the subject of substantial ongoing industry debate, and its resolution will have a significant impact on the application of U.S. swap requirements, and attendant costs, to asset managers and their clients.

Currently, the cross-border application of the U.S. swap regulatory regime is addressed to a limited extent by a final exemptive order issued by the CFTC in December 2012. This exemptive order, which expires on July 12, 2013, temporarily defines the term "U.S. person" using the criteria in the accompanying sidebar. Whether an asset manager's client is a U.S. person under the exemptive order's definition is a function of the place of organization of the client, not the status or location of the asset manager or the client's beneficial owners.

The exemptive order adopts temporary rules for the application of swap regulatory requirements applicable to CFTC-registered swap dealers or MSPs based on the U.S. person status of the counterparties to a swap. While the full details of the cross-border rules are beyond the scope of this memorandum, the general rule under the exemptive order is that a swap between a CFTC-registered swap dealer and a client will be subject to the full suite of U.S. swap regulations if one or both counterparties is a U.S. person. A swap will be exempt from most U.S. swap regulations if the client is a non-U.S. person and the swap dealer is either a non-U.S. person or a non-U.S. branch of a CFTC-registered U.S. swap dealer.

Since the U.S. swap regime applies differently based on whether the swap counterparties are U.S. persons, asset managers may consider reorganizing their swap trading activities to ensure that their non-U.S. clients do not unnecessarily or unintentionally become subject to U.S. regulations. For example, a non-U.S. swap dealer that engages in a block trade with an asset manager, which the asset manager will later allocate to both U.S. and non-U.S. clients, may as a practical matter need to treat the entire block as subject to U.S. swap rules, even if a direct trade between the non-U.S. swap dealer and a non-U.S. client would not be subject to U.S. swap rules. Whether avoiding this result by reorganizing swap trading activities to ensure that non-U.S. clients only trade with non-U.S. swap dealers is worthwhile will depend on whether other jurisdictions in which the asset manager transacts for non-U.S. clients adopt similar rules. The majority of G-20 countries are expected to adopt analogues of certain U.S. swap requirements, including mandatory clearing and margin, albeit on a different timeframe. The likelihood of the implementation of analogues of other requirements, including trade execution requirements, is less clear.

The exemptive order will expire on July 12, 2013, absent further action from the CFTC. The CFTC is currently working to finalize its previously proposed cross-border guidance, which may include a more expansive

version of the U.S. person definition that, for purposes of an asset manager's clients, looks not only to the place of organization of a client but to its direct and indirect owners and to the regulatory status of the asset manager. While the final definition remains unclear, it is likely that the final U.S. person definition adopted by the CFTC will be more expansive than the version in the exemptive order.

## Swap Reporting

To increase swap market transparency to regulators and the public, the Dodd-Frank Act established a new and comprehensive swap reporting regime. Under this regime, which is already effective, the **reporting counterparty** to a swap must report information about that swap to a swap data repository. Some of that information is publicly disseminated by the swap data repository in real time, while other information is only available to the CFTC and other regulators.

Where an asset manager transacts with a CFTC-registered swap dealer, the swap dealer is the reporting counterparty and neither the asset manager nor its client is primarily responsible for preparing and submitting swap data reports. However, asset managers should be aware of the specific information about their swaps that will be reported, as the availability of this information can inform, and may significantly change, swap trading strategies.

### Regulatory Reporting of Swap Data

The reporting counterparty to a swap must report specified, detailed information about the swap to a swap data repository. This information is available to the CFTC and other regulators but, with the exception of information that is publicly disseminated as described below, it is not available to the public. CFTC rules specify time periods within which the reporting counterparty must report the required information, which currently range from within 30 minutes to 48 hours after execution depending on the type of swap, the counterparties to the swap, the way in which it is executed and whether it is cleared. These time periods can be found in Appendix B.

The information required to be reported to a swap data repository can be classified into two general categories. "Creation data" includes the initial **primary economic terms** of a swap and all other terms agreed upon between the counterparties. These primary economic terms vary based on the asset class of the swap and include, among other data, the elements listed in the sidebar on the following page. "Continuation data" includes all changes to the primary economic terms of the swap that occur during the existence of the swap, including key lifecycle events such as material amendments, novations, assignments and partial terminations.

Neither an asset manager nor its client is primarily responsible for swap data reporting when entering into a swap with a CFTC-registered swap dealer. An asset manager or its client may be the reporting counterparty, however, where its counterparty functions as a swap dealer but is not

#### Reporting counterparty

The determination of which counterparty to a swap is the "reporting counterparty" for swap data reporting is determined according to the following waterfall:

- If only one counterparty is a swap dealer, the swap dealer is the reporting counterparty.
- If neither counterparty is a swap dealer, but one is an MSP, the MSP is the reporting counterparty.
- If both counterparties to a swap are end users and only one counterparty is a U.S. person, that U.S. person is the reporting counterparty.
- If both counterparties are U.S. person end users, and only one is a financial entity, the financial entity is the reporting counterparty.
- In all other cases, the counterparties choose which is the reporting counterparty.

#### Swap Data Repositories

Swap Data Repositories (SDRs) provide a central facility for swap data reporting. The following SDRs are registered with the CFTC:

- Chicago Mercantile Exchange Inc. for interest rate, credit, foreign exchange and other swaps;
- DTCC Data Repository for interest rate, credit, equity, foreign exchange and other swaps;
- ICE Trade Vault for commodity, credit and foreign exchange swaps; and
- INFX SDR, Inc for foreign exchange swaps.

required to register with the CFTC because its activity does not exceed the *de minimis* swap dealer registration threshold discussed above.

**Primary economic terms**

The primary economic terms of a swap vary by asset class of the swap, but generally include:

- the asset class of the swap;
- the notional amount of the swap;
- the start date and maturity or termination date of the swap;
- information about the underlying assets, payment terms, optionality and other features of the swap;
- whether the swap is an **allocation swap**;
- whether the swap is a **block trade**;
- the **unique swap identifier** and **unique product identifier** for the swap;
- the **legal entity identifier** of both counterparties to the swap and any agents that enter into the swap on behalf of a counterparty; and
- whether the swap will be cleared.

Even where a registered swap dealer is the reporting counterparty for a swap, asset managers should be aware of several responsibilities that apply directly to them and their clients in connection with swap data reporting:

- *LEIs and CICIs.* An asset manager will need to ensure that it and its clients (other than individuals) obtain a "**legal entity identifier**" (LEI). The CFTC has designated DTCC-Swift to provide an interim LEI, termed a CICI, until a global LEI system is established and operational. Asset managers and their clients must obtain a CICI for new and ongoing swaps by April 10, 2013. To do so, asset managers can visit the CICI Utility website at **https://www.ciciutility.org/**. Each asset manager, investment vehicle (or separately managed sleeves or sub-funds of an investment vehicle) and separately managed account client will need its own CICI.
- *Allocation Reporting.* An asset manager that enters into a swap that it later allocates among several of its clients is required to provide details of the allocation, including the identities of the ultimate counterparties to the swap, to the reporting counterparty as soon as technologically practical but no later than 8 hours after execution of the swap. Through at least June 30, 2013, longer periods are available for so-called "cross-jurisdictional allocation swaps." Specifically, an asset manager has up to 48 hours (plus up to 24 hours more to account for a holiday in the asset manager's jurisdiction) to provide allocation information to a reporting counterparty if the asset manager making the allocation and the swap dealer counterparty are located in different jurisdictions and are in time zones that are at least 4 hours apart. The reporting counterparty must provide the allocation information to the swap data repository, but the swap data repository will not publicly disseminate the allocation.
- *Errors or Omissions.* If a non-reporting counterparty becomes aware of any errors or omissions in data reported, the non-reporting counterparty must notify the reporting counterparty of the error or omission. The reporting counterparty would then be obligated to correct the information reported to the swap data repository. The non-reporting counterparty does not, however, have an affirmative obligation to check the data reported to the swap data repository.

The same reporting counterparty also must report specified information regarding "historical swaps" entered into before the effectiveness of the swap reporting rules described above to a swap data repository. The information that must be reported to a swap data repository for historical swaps is more limited than what is required to be reported for new swaps.

## Public dissemination of rounded notional or principal amounts

The notional or principal amount must be rounded as follows before public dissemination:

| Notional or principal amount of swap (*in dollars*) | Round to the nearest (*in dollars*) |
|---|---|
| Less than 5 | Disseminate at 5 |
| Less than 1,000 | 5 |
| Between 1,000 and 10,000 | 100 |
| Between 10,000 and 100,000 | 1,000 |
| Between 100,000 and 1 million: | 10,000 |
| Between 1 million and 100 million | 1 million |
| Between 100 million and 500 million | 10 million |
| Between 500 million and 1 billion | 50 million |
| Between 1 billion and 100 billion | 1 billion |
| Greater than 100 billion | 50 billion |

## Current Notional Caps

Until block sizes are determined, the notional caps will be as follows:

- *Interest rate swaps*:
  - Tenor up to two years: $250 million.
  - Tenor between two and ten years: $100 million
  - Tenor greater than ten years: $75 million
- *Credit swaps*: $100 million
- *Equity swaps*: $250 million
- *Foreign exchange swaps:* $250 million
- *Other commodity swaps:* $25 million

## Public Dissemination of Swap Data

Certain information reported by a reporting counterparty to a swap data repository is publicly disseminated in real time in an anonymous manner. While asset managers generally are not responsible for reporting this information directly, they should be aware of the information relating to their swap transactions that is being publicly disseminated, the methods employed to help ensure anonymity and the availability of other market participants' swap information that could be useful to the asset manager in determining swap trading strategies.

The information that swap data repositories publicly disseminate includes the rounded notional amount of the swap, the underlying assets for a swap and information necessary to enable market participants to evaluate the price of the swap, including the yield, spread, coupon, premiums and other pricing terms. Critically, however, much of the information reported to the swap data repository, including the identities of the counterparties, is not publicly disseminated. In addition, the CFTC has established regulatory safeguards to protect swap counterparty anonymity in illiquid markets, where market participants may be able to infer the identity of a counterparty based on trading behavior. These include:

- *Rounded notional amounts and notional caps.* Rather than publicly disseminating the precise notional amount of a swap, swap data repositories round the notional values according to the CFTC-produced schedule in the accompanying sidebar. For example, if a swap's notional amount is anything between $1 million and $100 million, the notional amount is rounded to the nearest one million dollars before it is publicly disseminated. In addition, all swaps with a notional size above a specified **notional cap** are simply reported as being larger than that cap. The notional cap will be calculated based on market data on trading activity in that swap using a similar methodology used to calculate the block threshold for a specific swap category, described further below. Until block rules are adopted and in place, however, the notional caps in the accompanying sidebar apply.

- *Allocation swaps.* The details of subsequent allocations for allocation swaps are generally not publicly reportable. The initial transaction with (but not the identity of) the asset manager or other agent is reported, but the amounts allocated to individual, ultimate counterparties and the identities of those ultimate counterparties are not subject to public dissemination.

- *Other commodity swaps.* All arm's-length swaps in the interest rate, foreign exchange, credit and equity asset classes are subject to real-time reporting. However, to avoid indirect identification of parties in illiquid commodity asset classes, the CFTC currently does not require real-time reporting of swaps in any other asset classes, such as commodity, metal and energy swaps, unless the swap is based on one of the 28 specified physical commodities listed in Appendix C.

### *Timing of Public Dissemination*

Swap data repositories must publicly disseminate transaction and pricing data immediately upon receiving it from the reporting counterparty. However, if the trade is large enough to qualify as a "**block trade**," the swap data repository will delay public dissemination for a specified period of time which ranges from 15 minutes to 4 hours (for swaps with a swap dealer or MSP counterparty). Longer delays are available for the first year after block thresholds are established, as well as for swaps where neither counterparty is a CFTC-registered swap dealer or MSP. These time periods can be found in Appendix D.

## Proposed Block Trade Rules

The CFTC has proposed, but has not yet adopted, rules defining what constitutes a "block trade" for the purposes of the delay in public dissemination. Under the CFTC's proposal, each swap asset class would be divided into a number of categories based on information the CFTC believes is relevant in determining the liquidity of a swap product, as follows:

- *Interest rate swaps* would be divided into 8 tenor groups and 3 currency groups, for a total of 24 categories, each of which would have its own block threshold.
- *Credit swaps* would be divided into 6 tenor groups and 3 spread groups, for a total of 18 categories, each of which would have its own block threshold.
- *Foreign exchange derivatives* (other than foreign exchange forwards and foreign exchange swaps, as defined above) would be divided into one category for each unique currency combination.
- *Other commodity swaps* that are not exempt from real-time reporting would be divided into a number of groups based on the underlying asset. This category includes swaps that are not included in the interest rate, credit, foreign exchange and equity asset classes, such as swaps on physical commodities.
- *Equity swaps* would not be subject to block trade delays.

After an initial period, during which block trade sizes will be determined using specified rules in the proposal, the block trade threshold for each category would be determined using a "67% methodology" that is described in the accompanying sidebar. Despite the "67% methodology" name, it is not the case that 33% of all swaps in a category will be block trades; instead, the number of block trades will depend on the distribution of notional amounts in the swap category. When the block trade rule was proposed, CFTC Commissioner Sommers noted that, under this methodology and based on the distribution of interest rate swap and credit default swaps at that time, only the largest 6% of interest rate swaps and credit default swaps would be block trades. Until final block trade rules are adopted and effective, all swap transactions are treated as block trades and are subject to the delay for public data dissemination.

**67% methodology**

The 67% methodology generally entails:

- ordering all publicly reportable swaps in the relevant category (excluding outliers) by their notional amounts;
- determining the first swap for which 67% of the total notional amount of swaps in that category is comprised of swaps with a smaller notional size than that swap; and
- taking the notional size of the smallest such swap as the block threshold.

Public reporting of pricing and transaction data for swaps is likely to affect how swap market participants trade swaps, particularly as swap trading moves to electronic trading platforms and exchanges. Access to more information about the swap markets may present opportunities for asset managers, but it also leads to concerns about ensuring anonymity of trades.

When final block trading rules are adopted, asset managers should assess their trading activities to evaluate the potential advantages of block trading. Although asset managers that transact with swap dealers have no regulatory obligation to monitor the swap data reporting of their swap dealer counterparties, they may wish to keep a close eye on the information about their swap transactions that is being publicly disseminated.

**Interest Rate Swaps Subject to Mandatory Clearing**

- "**Fixed-to-floating swap**." A swap in which the payment or payments owed for one leg of the swap is calculated using a fixed rate and the payment or payments owed for the other leg are calculated using a floating rate.
- "**Floating-to-floating swap**" or "**basis swap**." A swap in which the payments for both legs are calculated using floating rates.
- "**Forward Rate Agreement**." A swap in which payments are exchanged on a pre-determined date for a single specified period, and one leg of the swap is calculated using a fixed rate and the other leg is calculated using a floating rate that is set on a predetermined date.
- "**Overnight indexed swap**." A swap for which one leg of the swap is calculated using a fixed rate and the other leg is calculated using a floating rate based on a daily overnight rate.

## Swap Clearing

A cornerstone of the Dodd-Frank Act's swap provisions is the requirement that market participants clear standardized swaps through central counterparties, generally known as derivatives clearing organizations or clearinghouses. The CFTC is charged with determining which swaps are sufficiently standardized to warrant mandatory clearing. In November 2012, the CFTC designated for mandatory clearing the first cohort of swaps, which includes two types of credit default swaps and several types of interest rate swaps. The clearing requirement will be phased in according to the type of market participants that are counterparties to a designated swap; the first clearing requirement under this phase-in begins on March 11, 2013.

For asset managers accustomed to futures trading, the swap clearing arrangements and margin requirements will be familiar. Swap clearing will entail developing new relationships with members of clearinghouses and posting both initial margin (independent amounts) and variation margin (mark-to-market amounts) to clearing members, regardless of creditworthiness. Asset managers that previously engaged only in bilateral, uncleared swap transactions may need to make arrangements with new service providers and rethink how cleared swaps fit into trading programs, including evaluating the costs of using different means to obtain similar exposures.

### Swaps Currently Mandated for Clearing

To date, the CFTC has designated several specific classes of interest rate swaps and credit default swaps as subject to mandatory clearing.

- *CDS*. The CFTC has designated for mandatory clearing specified tenors of recent series of the untranched CDX North American Investment Grade and High Yield indices and the untranched iTraxx Europe, iTraxx Europe Crossover and iTraxx Europe HiVol indices.
- *IRS*. The CFTC has designated for mandatory clearing specified tenors of fixed-to-floating, floating-to-floating, forward rate agreement and overnight indexed swaps denominated in U.S. dollars, euros, British pounds and (other than for overnight

indexed swaps) Japanese yen. These terms are defined in the sidebar on the previous page.

The CFTC has not yet proposed clearing requirements for other swaps in the interest rate or CDS asset classes or for other swap asset classes, including energy swaps, commodity swaps and non-deliverable forwards but may do so in the future.

**Mandatory Clearing Dates for First Determination Products:**

- **March 11, 2013** for designated swaps between Category 1 entities, other than iTraxx CDS indices;
- **April 26, 2013** for swaps on iTraxx CDS indices between Category 1 entities;
- **June 10, 2013** for designated swaps between Category 2 entities, and between Category 1 and Category 2 entities, other than iTraxx CDS indices;
- **July 25, 2013** for swaps on iTraxx indices between Category 2 entities, and between Category 1 and Category 2 entities;
- **September 9, 2013** for designated swaps involving all other market participants, including those with "third-party subaccounts", other than iTraxx CDS indices;
- **October 23, 2013** for swaps on iTraxx indices involving all other market participants, including those with "third-party subaccounts."

## Clearing Timing

The compliance date for any specific CFTC clearing determination will be phased in according to the type of market participants that are counterparties to the swap. It is important for an asset manager to understand the three primary counterparty classifications provided in the phase-in rule to determine the appropriate classification, and therefore clearing compliance date, for each of its clients.

The first mandatory clearing deadline applies to swaps between "Category 1" entities, which include CFTC-registered swap dealers and MSPs and "active funds." An "active fund" is any private fund, other than a third-party subaccount (defined below), that executes 200 or more swaps per month based on a monthly average over the preceding 12 months, beginning on November 1, 2012. Category 1 entities must clear designated swaps executed on or after 90 days following the publication of an applicable CFTC mandatory clearing determination.

The second mandatory clearing deadline applies to swaps between a Category 1 entity and a Category 2 entity, or between two Category 2 entities. "Category 2" entities include commodity pools, private funds (other than active funds) and persons predominantly engaged in banking or financial activities. Category 2 entities also include asset managers, registered investment companies and pooled investment vehicles other than those managed through a separate account arrangement that qualifies as a "third-party subaccount," as discussed below. Designated swaps subject to the second clearing deadline must be cleared if they are executed on or after 180 days following the publication of a CFTC mandatory clearing determination.

The third and final mandatory clearing deadline applies to swaps entered into by counterparties that are not Category 1 or Category 2 entities. This includes swaps where one counterparty is a "third-party subaccount," an ERISA plan or a non-financial end user. A "third-party subaccount" is a client account managed by an unaffiliated and independent asset manager where the asset manager is responsible for the documentation necessary for the account's owner to clear swaps. Designated swaps subject to the third clearing deadline must be cleared if they are executed on or after 270 days following the publication of a CFTC mandatory clearing determination.

The accompanying sidebar shows the mandatory clearing deadlines for the first set of CDS and interest rate swaps described above. Leading up to these deadlines, swap dealers will be asking each of their counterparties, including asset managers and their clients, to identify the phase-in category applicable to the counterparty.

## Accessing the Clearinghouse through a Clearing Member

In order to directly submit a swap for clearing at a clearinghouse, a market participant must be a member of that clearinghouse. Clearinghouse membership requires significant capitalization and operational infrastructure. In addition, members of a clearinghouse take on the risk of the failure of other members of the clearinghouse. Clearing members are generally banks and other financial institutions with the largest swap businesses, and asset managers generally have not been swap clearing members. As the cleared swap markets develop, however, clearinghouses may provide for specialized membership structures to encourage membership and more direct swap clearing by asset managers.

Asset managers that are not clearing members will need to arrange for one or more clearing members to clear their swaps. Clearing members that clear swaps on behalf of customers must be registered with the CFTC as futures commission merchants (FCMs). Market participants often contract for clearing services from more than one FCM so that, if the primary FCM fails, positions can be "ported" to another clearing member of the clearinghouse instead of becoming subject to an unwind process.

The documentation needed to clear swaps continues to evolve. At a high level, the swap clearing relationship between a customer and an FCM clearing member is based on three primary documents. First, the customer and FCM clearing member execute a base Futures and Options Agreement that generally describes the relationship between the two counterparties. Second, the customer and clearing member execute an OTC Clearing Addendum to the Futures and Options Agreement that provides specific provisions related to the clearing of swaps. This OTC Clearing Addendum is based on a standard form developed by the FIA and ISDA and contains a number of provisions that can be negotiated between the parties. The final document is the Cleared Derivatives Execution Agreement, which includes provisions relating to circumstances where swaps are not successfully cleared. The Cleared Derivatives Execution Agreement is also based on a standard form developed by the FIA and ISDA.

## Margin for Cleared Swaps

All counterparties to a cleared swap must post initial margin (independent amounts) and pay variation margin (mark-to-market amounts) on cleared swaps to their FCM clearing member, who will post that margin to the clearinghouse. The amount of initial margin required for cleared swap transactions is calculated by the clearinghouse based on internal models. These models must use a minimum liquidation time of one day for agricultural, energy and metal swaps and five days for all other swaps.

FCM clearing members may also require their customers to post collateral for cleared swaps in excess of the amounts required by the clearinghouse to the FCM clearing member, which may be held either by the FCM clearing member or the clearinghouse depending on negotiated arrangements and clearinghouse rules. For this reason, asset managers may wish to negotiate clearing arrangements with more than one FCM, as the amount of initial margin that an FCM may require in excess of the clearinghouse minimum may be a significant factor in the cost of cleared swaps.

### Swap Execution Facility

A swap execution facility (SEF) is a trading system, platform or facility in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system. A SEF includes any trading facility that facilitates the execution of swaps between persons and is not a designated contract market. As SEF rules have not yet been adopted by the CFTC, there are currently no registered SEFs.

### Designated Contract Market

A designated contract market (DCM) is an exchange that is registered with the CFTC as a contract market under the Commodity Exchange Act. DCMs are most like traditional futures exchanges, which may allow access to their facilities by all types of traders, including retail customers. DCMs may list for trading futures or option contracts based on any underlying commodity, index or instrument. As of March 11, 2013, there are 18 CFTC-designated DCMs.

Collateral posted to satisfy initial margin requirements for cleared swaps will be held at the clearinghouse in accordance with the CFTC's recently adopted "legally segregated, operationally commingled," or "LSOC," rule, which aims to protect non-defaulting customers of a clearing member from losses incurred by defaulting customers of the same clearing member. The LSOC rule also provides for the possibility of customer collateral being held in an independent custody account. Such accounts may facilitate porting of customer positions and provide some other benefits; however, issues remain concerning the required *pro rata* distribution of customer assets in the case of an FCM clearing member bankruptcy.

The amount of initial margin that will be required for cleared swaps may be larger than the initial margin, if any, posted by asset managers today. However, cleared swap margin amounts are likely to be significantly smaller than the margin requirements for uncleared swaps, described below.

## Swap Trading

The Dodd-Frank Act imposes new swap execution requirements that will fundamentally change the way in which the most liquid swaps are traded. As these rules are adopted, and execution of these swaps on platforms becomes mandatory, asset managers will need to consider the liquidity, price, information and other impacts that a move from bilateral negotiation and execution of swaps to a more exchange-like system may have.

Any swap, other than a block trade, that is subject to mandatory clearing must be executed on a designated contract market (DCM), which is a futures exchange registered with the CFTC, or on a new type of regulated trading marketplace called a swap execution facility (SEF), if an exchange or SEF makes the swap "available to trade." In January 2011, the CFTC proposed rules to govern the operation of SEFs and how swaps would be traded on SEFs and exchanges. Under the proposed rules, transactions subject to the mandatory trade execution requirement must be executed through an order book or a request for quote (RFQ) system. The CFTC explicitly stated in proposing these rules that one-to-one voice services and single-dealer platforms do not satisfy the mandatory trade execution requirement. Other trades, including swaps that are not subject to mandatory clearing and block trades, may be executed through an order book, RFQ system, a voice-based system or any other system for trading that is permitted by the CFTC.

The proposed RFQ system has been particularly controversial, as it would require each market participant to request a quote from at least 5 market participants on the SEF. This requirement would apply to all types of market participants, including asset managers. For swaps subject to the mandatory trade execution requirement, this proposed rule would preclude the common practice of bilaterally negotiating transactions. In a recent survey of buy-side market participants conducted by the SIFMA Asset Management Group, ISDA and the Managed Funds Association, nearly 70% of respondents indicated that they would migrate to other markets if required to post five RFQs.

**Made Available to Trade**

In determining whether a swap is made “available to trade,” an exchange or SEF must consider the following factors:

- whether there are ready and willing buyers and sellers;
- the frequency or size of transactions on SEFs and exchanges, or of bilateral transactions;
- the trading volume on SEFs, exchanges or of bilateral transactions;
- the number and types of market participants;
- the bid/ask spread;
- the usual number of resting firm or indicative bids and offers;
- whether a SEF’s trading system or platform or an exchange’s trading facility will support trading in the swap; or
- any other factor that the SEF or exchange may consider relevant.

A swap is only subject to these trade execution requirements if a SEF or exchange makes the swap “available to trade.” The CFTC has interpreted the phrase to mean that a minimum amount of liquidity exists on the platform and that an affirmative “available to trade” determination has been made. Under the CFTC’s proposal, this determination would be made by a SEF or exchange, using factors established by the CFTC, and would be subject to review by the CFTC. It is not yet clear what portion of the swap market will meet this threshold and will be subject to trading on a SEF or exchange.

As of this writing, proposed SEF rules have not been adopted and no SEFs are currently registered. In addition, few swaps currently trade on exchanges. Thus, even though, as discussed above, the first category of swaps will be subject to mandatory clearing beginning on March 11, 2013, the mandatory trade execution requirement will likely not become effective for some time. However, the CFTC is expected to adopt its SEF rules in the near future. Asset managers should keep themselves apprised of developments in this area, as the swap trading rules are likely to significantly affect the manner in which they can execute swap transactions on behalf of their clients.

## Uncleared Swap Margin

Some swaps will continue to be transacted bilaterally without being cleared; for example, where a swap is not required to be cleared (and the counterparties do not choose to clear it) or where the counterparties elect to rely on a clearing exception. Under proposed rules, subject to exemptions, uncleared swaps would generally be subject to initial and variation margin requirements, with floors for those requirements set by regulation. The amount of initial margin required for uncleared swaps will generally exceed that required for cleared swaps, making uncleared swaps relatively expensive and promoting the use of standardized, clearable instruments. No uncleared swap margin rules have yet been adopted; however, we expect that regulators will move forward this year to adopt final rules.

These uncleared swap margin requirements, when adopted and effective, will represent a dramatic change from current practice where many asset managers are able to trade for their clients without posting initial margin. Asset managers will need to decide whether their clients are better served by using bespoke swaps, which may more closely meet a client’s specific investment or hedging needs but at a higher margin cost, or by using standardized swaps that will be less costly but will require new intermediary relationships and may not perfectly meet the client’s needs.

Uncleared swap margin rulewriting authority under the Dodd-Frank Act is divided between two sets of regulators. The U.S. banking regulators—primarily the Federal Reserve, FDIC and Office of the Comptroller of the

Currency—are responsible for adopting uncleared swap margin rules for banks that are swap dealers,[1] while the CFTC is responsible for adopting uncleared swap margin rules for nonbank swap dealers. As a result, unless the adopted margin rules are consistent, an asset manager transacting in the same uncleared swap for the same client could be subject to the banking regulators' rules if the swap dealer counterparty is a bank, or the CFTC's rules if the swap dealer counterparty is not a bank. Fortunately, the banking regulators and CFTC proposed uncleared swap margin rules in April 2011 that are parallel in many respects.

The proposed uncleared swap margin rules would require swap dealers to collect margin from their counterparties but not to post margin to their counterparties. That is, the initial and variation margin requirements proposed are unilateral—a swap dealer would not be required to post initial and variation margin to its counterparty, other than where both counterparties are swap dealers and the collection rules apply to both.

The initial margin requirement can be calculated by the swap dealer using a standardized method or an approved model, which must calculate initial margin requirements based on a minimum 10-day liquidation period at a 99% confidence interval and may provide limited risk offsets within asset classes. The amount of margin required by different swap dealers for a given transaction or to a given counterparty may differ. While the model must be "independently verifiable," the swap dealer is not required by regulation to provide the model to its counterparties.

Under both sets of proposed rules, swaps between a swap dealer and a financial entity would be subject to limited uncollateralized thresholds for both initial and variation margin, but only if the financial entity is a "low-risk financial end user," defined as a financial entity that:

- does not have "significant swaps exposure," defined as half of the thresholds that would require the entity to register as an MSP;
- predominantly uses swaps or security-based swaps to hedge or mitigate the risks of its business activities; and
- is subject to capital requirements established by a prudential regulator or state insurance regulator.

Financial end users that meet all three of these requirements would be allowed to maintain an uncollateralized threshold, proposed to be the smaller of a specific dollar amount between $15 million and $45 million and a percentage of the swap dealer's capital between 0.1% and 0.3%. Financial end users that do not meet this requirement, referred to as "high-risk financial end users," would not be allowed to maintain any uncollateralized threshold and would be required to post the full amount of

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[1] The proposed margin requirements are similar for swap dealers and MSPs. Since asset managers are likely to have very few MSP counterparties, we focus here on swap dealers.

### Eligible Collateral

Under both the bank regulators' and CFTC's proposals, swap dealers may only accept as collateral:

- cash;
- U.S. obligations; or
- for initial margin only, senior GSE debt obligations or any obligation that is an "insured obligation" of a Farm Credit System bank.

Haircuts will apply to non-cash collateral as follows (as a percentage of market value):

| | 0–5 years | 5–10 years | More than 10 years |
|---|---|---|---|
| **U.S. Obligations** | | | |
| Bills/ Notes/ Bonds/ Inflation Indexed | 98–100 | 95–99 | 94–98 |
| Zero coupon, STRIPs: | 97–99 | 94–98 | 90–94 |
| **Senior GSE debt obligations or FCS insured obligations** | | | |
| Bills/ Notes/ Bonds | 96–100 | 94–98 | 93–97 |
| Zero Coupon | 95–99 | 93–97 | 89–93 |

initial and variation margin calculated by the swap dealer, subject to a $100,000 minimum transfer amount. Since most typical financial entity clients of asset managers, such as registered investment companies, private funds, pension plans and endowments, are not subject to prudential regulator capital requirements, these clients would be considered "high-risk financial end users" not eligible for initial margin thresholds.

The uncleared swap margin proposals limit the types of collateral that can be collected by swap dealers to meet the uncleared swap margin requirements, as listed in the sidebar. Since only the most liquid instruments are allowed as collateral, asset managers may be forced to exchange less liquid but highly performing assets for lower-return assets in order to post them as collateral, which could decrease client returns.

Counterparties to uncleared swaps have the right to require a swap dealer to segregate their posted initial margin and have that margin held at an independent third-party custodian. Segregation may, however, increase the costs to the swap dealer and be passed through to the counterparty.

The margin requirements are not expected to apply to swaps entered into before final rules are in effect. The bank regulators have, however, proposed to allow a bank swap dealer, for a particular master netting agreement, to include in initial margin calculations all swaps entered into before, on, or after the effective date of the margin rule. The swap dealer may not, however, choose to include some pre-effectiveness swaps and exclude others.

While U.S. regulators work to adopt final uncleared swap margin rules, an international effort is underway to develop consistent uncleared swap margin standards. This effort is being led by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO). While the BCBS/IOSCO approach is largely similar to the U.S. regulators' proposal, it differs in several key details, including applying the margin requirements to all uncleared derivatives rather than only to swaps and security-based swaps, requiring bilateral exchange of margin, applying the initial margin requirement only to entities in consolidated groups with more than €8 billion of uncleared derivatives exposure and allowing for a standard €50 million initial margin threshold between consolidated groups, regardless of regulatory status.

# Swap Dealer Business Conduct and Swap Documentation Rules

In addition to changing the traditional manner in which swaps are executed and collateralized, the new swap regulatory regime alters the relationship between a swap dealer and its counterparties.[2] The regulations will require swap dealers to enter into new swap trading relationship documentation with counterparties, provide new disclosures to customers and develop and formalize methods of acknowledging and confirming swap trades. While these requirements apply directly to swap dealers rather than to their counterparties, as a practical matter a swap dealer will be prohibited from trading with a counterparty as of the rules' compliance dates unless the required documentation is signed and the required representations are provided to the swap dealer.

This documentation can be complicated and time-consuming to complete, and asset managers will need to make representations not only on their own behalf but also for their clients. Asset managers should therefore begin the process of understanding the requirements, educating their clients and negotiating with swap dealers well in advance of the May 1, 2013 general compliance date for the business conduct requirements to avoid unnecessary disruptions to trading. Below, we describe the key aspects of the business conduct and swap relationship documentation rules and introduce the ISDA Protocol process through which many market participants will satisfy these rules.

## Business Conduct Requirements

The CFTC has adopted "external business conduct" rules that govern the relationship between a swap dealer and any non-swap dealer counterparty with whom they enter into a swap, offer to enter into a swap, recommend a swap or advise on swap trading strategies. These business conduct requirements can be classified into three broad categories: requirements relating to the verification of counterparty eligibility to enter into swaps; disclosure requirements; and suitability and sales practice standards.

- *Verification of counterparty eligibility.* Swap dealers must verify that each prospective counterparty is an **eligible contract participant** and must determine whether each prospective counterparty is a special entity. If the prospective counterparty is a special entity, the swap dealer must confirm that the special entity has a representative independent from the swap dealer or, for ERISA special entities, a fiduciary that is qualified to assess the suitability of swaps on behalf of the special entity counterparty. Swap dealers will generally require that the counterparty make representations

**Eligible Contract Participant**

The term "eligible contract participant" includes, among others:

- swap dealers and MSPs;
- financial institutions (including banks, federal or state credit unions, foreign banks, financial holding companies and trust companies);
- regulated insurance companies;
- corporations, partnerships, and other entities with at least $10 million of total assets;
- commodity pools with at least $5 million of total assets and an operator that is subject to CFTC or foreign regulation (with additional requirements for retail foreign exchange transactions); and
- individuals with at least $10 million of investments.

In addition, to the requirement that a swap dealer must verify that each prospective counterparty is an eligible contract participant, only eligible contract participants can enter into swaps bilaterally.

[2] Similar rules apply to MSPs. However, since asset managers are likely to have very few MSP counterparties, we focus here on swap dealers.

needed to satisfy these requirements before discussing or negotiating any particular swap transaction.

- *Disclosure requirements.* Prior to executing a swap, a swap dealer must disclose to its counterparty information about the material characteristics and risks of a swap, any conflicts of interest (including how the swap dealer is compensated) and a pre-trade mid-market mark for the swap to assist the counterparty in understanding the pricing of the swap. A counterparty may also request that the swap dealer provide it with a scenario analysis. After execution of a swap, the swap dealer has an ongoing obligation to provide its counterparty with a mid-market mark for the swap on a daily basis. For cleared swaps, this daily mark can be obtained directly from the clearinghouse. The external business conduct rules require that the swap dealer and its counterparty agree on the form in which these disclosures are provided.
- *Suitability and other sales practice standards*. When recommending a swap, a swap dealer must ensure that the swap is suitable for its prospective counterparty. Heightened suitability requirements apply when a swap dealer is providing tailored advice about a swap to a prospective counterparty that is a special entity. To a large extent, these suitability requirements can be satisfied by a swap dealer obtaining representations that a counterparty is not relying on the swap dealer's recommendation to enter into a swap. For special entity counterparties (other than ERISA special entities) a swap dealer must ensure that the counterparty has a representative independent of the swap dealer that is qualified to assess and enter into swaps on the special entity's behalf. For ERISA special entities, a swap dealer must ensure that the special entity has a fiduciary. Swap dealers are also subject to a fair dealing requirement and specific anti-fraud and anti-manipulation provisions.

As a practical matter, swap dealers will need their counterparties to provide them with representations to meet many of the requirements listed above. Many clients will expect their asset managers to educate them as to the requests they are receiving and help them to provide swap dealers with the information needed to avoid disruptions in trading. Depending on particular arrangements with their clients, asset managers may provide the required representations to, and receive information from, swap dealers on behalf of their clients.

*Special entities.* As mentioned above, swap dealers owe heightened duties to special entity counterparties. Asset managers that advise non-ERISA special entities may need to serve as an independent representative to the special entity. The rules specify the conditions under which a representative will qualify as such for purposes of the business conduct requirements. Advisers to an ERISA special entity may need to be identified as the special entity's fiduciary for these purposes.

Swap dealers may seek to obtain representations from an asset manager regarding its status as an independent representative or fiduciary. Asset managers may need to implement policies and procedures to ensure they

can make these representations or otherwise satisfy swap dealer counterparties that the applicable requirements have been met.

### Swap Trading Relationship Terms

Terms required to be contained in swap trading relationship documentation:

- payment obligations;
- netting arrangements;
- events of default or other termination events and calculation and netting of payments upon termination;
- transfer of rights and obligations;
- governing law;
- valuation;
- dispute resolution;
- credit support arrangements, including, if applicable, initial and variation margin requirements, types of assets that may be used as collateral, haircuts applied to collateral, investment and rehypothecation, and custodial arrangements for collateral; and
- all confirmations of swap transactions.

## Swap Documentation

In addition to the external business conduct requirements, the CFTC has adopted rules that require swap dealers to have relationship documentation and cover the exchange of information between swap dealer and counterparty through acknowledgments and confirmations. As with the external business conduct rules, the direct regulatory requirement for the documentation rules rests on a swap dealer; however, asset managers and their clients will necessarily be affected as they may need to enter into new documentation with, and may receive additional or different information from, their swap dealers in connection with swap transactions.

*Swap trading relationship documentation.* A swap dealer must enter into written relationship documentation with each of its counterparties. This documentation must include all terms governing the trading relationship between the swap dealer and the counterparty. While these requirements may reflect existing documentation practices in some swap markets, counterparties in other markets have transacted with more limited relationship documentation or no documentation at all. Once these requirements become effective on July 1, 2013, swap dealers will be unable to trade with a counterparty without first having in place documentation sufficient to meet the regulatory requirements.

*Confirmations and acknowledgements.* A swap dealer must execute a confirmation with each counterparty, and for non-swap dealer counterparties, must also provide an acknowledgement, within specified timeframes after the execution of a swap. An acknowledgement, which is a written record of all of the terms of the swap, must generally be provided by the swap dealer to a non-swap dealer counterparty as soon as technologically practicable, but no later than the end of the first business day following the business day a swap is executed. For swaps with counterparties that are swap dealers or financial entities, a written confirmation must be executed in the same timeframe. Swap dealers have an additional business day within which to execute a confirmation for counterparties other than financial entities, such as commercial end users. All of these requirements are subject to phase-in schedules which provide additional time within which to provide acknowledgments or confirmations. The acknowledgement and confirmation requirements do not apply for cleared swaps. They also do not apply to swaps that are traded on a SEF or exchange, between execution and the time the swap is cleared, as long as the swap is ultimately cleared.

Although swap dealers historically have provided some of this information to their counterparties, the new rules require swap dealers to formalize the confirmation process and to ensure, as a regulatory matter, that acknowledgments are provided and confirmations are executed.

## The ISDA Protocols and Markit

Asset managers that have been trading with swap dealers likely have already been asked by their counterparties to enter into the ISDA Dodd-Frank Protocol or to otherwise amend their or their clients' documentation.

The ISDA Dodd-Frank Protocol is an industry effort to satisfy Dodd-Frank Act requirements through a series of multilateral adherence processes, similar to ISDA's 2009 "Big Bang" protocol. The Protocol allows for various standardized amendments to be made to the relevant agreements between any two adhering parties.

To adhere to the Protocol, a market participant must sign an "adherence letter" that binds it to the Protocol and must complete a questionnaire that solicits key information and representations. The questionnaire allows the market participant to opt in or out of a number of "schedules," which contain the operative amendments to an ISDA master agreement or other master swap relationship agreement. ISDA has teamed with Markit to develop an online solution, called ISDA Amend, to automate this process. On ISDA Amend, an adhering party lists the counterparties with whom it wants to amend its master documentation through the Protocol. When a match is made between two counterparties, the questionnaires are exchanged, and the master agreement between the counterparties is amended at that point.

ISDA intends to release a series of Protocols to facilitate compliance with new swap regulatory requirements as they are adopted and become effective. The first Protocol, known as the August 2012 Dodd-Frank Protocol (or Protocol 1.0), is primarily designed to address the external business conduct rules. Market participants can currently adhere to this Protocol via ISDA Amend in preparation for the rules' May 1, 2013 general compliance date. ISDA has also released a draft of its second set of Protocol documents (known as Protocol 2.0), which primarily address the swap trading relationship documentation rules.

ISDA Amend does not provide a method for counterparties to customize or amend the standardized Protocols. Although it may be more costly or time consuming, some market participants are seeking to negotiate bilateral amendments to their swap arrangements to address the requirements of the external business conduct and swap documentation rules in a way they feel is more appropriate or advantageous to them. Asset managers may wish to assess, depending on the nature and size of their swap trading activities and their clients' specific needs, whether the multilateral standardized ISDA Amend process is sufficient or whether individualized bilateral negotiations would better serve their clients.

## Position Limits and Large Trader Reporting

Asset managers that have historically traded futures contracts are likely familiar with the CFTC's position limits and large trade reporting regimes. The CFTC is in the process of expanding these regimes to cover swap trading.

### Position Limits

In 2011, the CFTC adopted rules that expanded its futures position limits to incorporate new speculative (*i.e.*, non-hedging) limits on swaps, swaptions, futures and options on futures that reference any one of 28 specified agricultural, energy or metals futures contracts or the same underlying commodities that are listed in Appendix C. These highly controversial rules

were scheduled to go into effect starting in October 2012 but were vacated by the U.S. District Court for the District of Columbia in September 2012, in response to a challenge by two industry groups. The CFTC has appealed the District Court's ruling and also, apparently, plans to re-propose position limit rules. Asset managers should stay informed of developments in this area, as these position limit rules could materially affect their swap trading activities.

### Large Swap Trader Reporting

The CFTC's large trader program is a market surveillance tool designed to give the CFTC insight into transactions in physical commodity markets. The CFTC has expanded its futures large trader program to cover swaps, swaptions, futures and options on futures referencing 46 enumerated commodity futures contracts or the same underlying commodity. These rules require swap dealers and FCMs to submit reports to the CFTC when customer positions are above specified reporting thresholds. While asset managers are not directly subject to a reporting requirement under these rules, asset managers or their clients are obligated to respond to CFTC requests for additional information (known as "special calls") about their positions and trading activities.

## Recordkeeping

All swap counterparties are subject to a requirement to keep "full, complete and systematic records" of their swaps. These records must be maintained through the life of the swap and for five years following termination of the swap and are subject to inspection by the CFTC, the SEC and the U.S. Department of Justice.

As a practical matter, these new recordkeeping requirements are unlikely to require an asset manager to retain records that it is not already required to maintain by virtue of being a registered investment adviser subject to the books and records rule under the Investment Advisers Act of 1940 or being a registered commodity pool operator or commodity trading advisor. Nevertheless, asset managers should ensure that their recordkeeping policies and procedures reflect their regulatory recordkeeping obligations under the swap regulations.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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## Registration as a Commodity Pool Operator or Commodity Trading Advisor

Asset managers must now take their client's swap positions into account when determining whether they must register with the CFTC as a commodity pool operator (CPO) or commodity trading advisor (CTA). This requirement is based on statutory changes to the Commodity Exchange Act by the Dodd-Frank Act, which included swaps in the list of "commodity interests" that could cause an investment vehicle to be a commodity pool, the operator of that pool to be subject to registration as a CPO and a person providing advice regarding swaps for compensation to be a CTA. The CFTC further broadened the scope of the registration requirements for CPOs by eliminating a key exemption from registration as a CPO, former Regulation 4.13(a)(4), upon which many private fund managers relied, and by narrowing the scope of the Regulation 4.5 exclusion from regulation as a CPO for operators of registered investment companies. A limited exemption from CPO registration remains available with respect to commodity pools that limit their trading in commodity interests to specified *de minimis* limits.

Absent an exemption, CPOs and CTAs, and their principals and associated persons, are required to register with the CFTC and the NFA and are subject to significant ongoing compliance, disclosure, anti-fraud and reporting obligations. While a full discussion of these requirements is beyond the scope of this memorandum, we suggest a review of our recent client memorandum (available at **http://www.davispolk.com/files/uploads/CPO.CTA.pdf**) for useful background.

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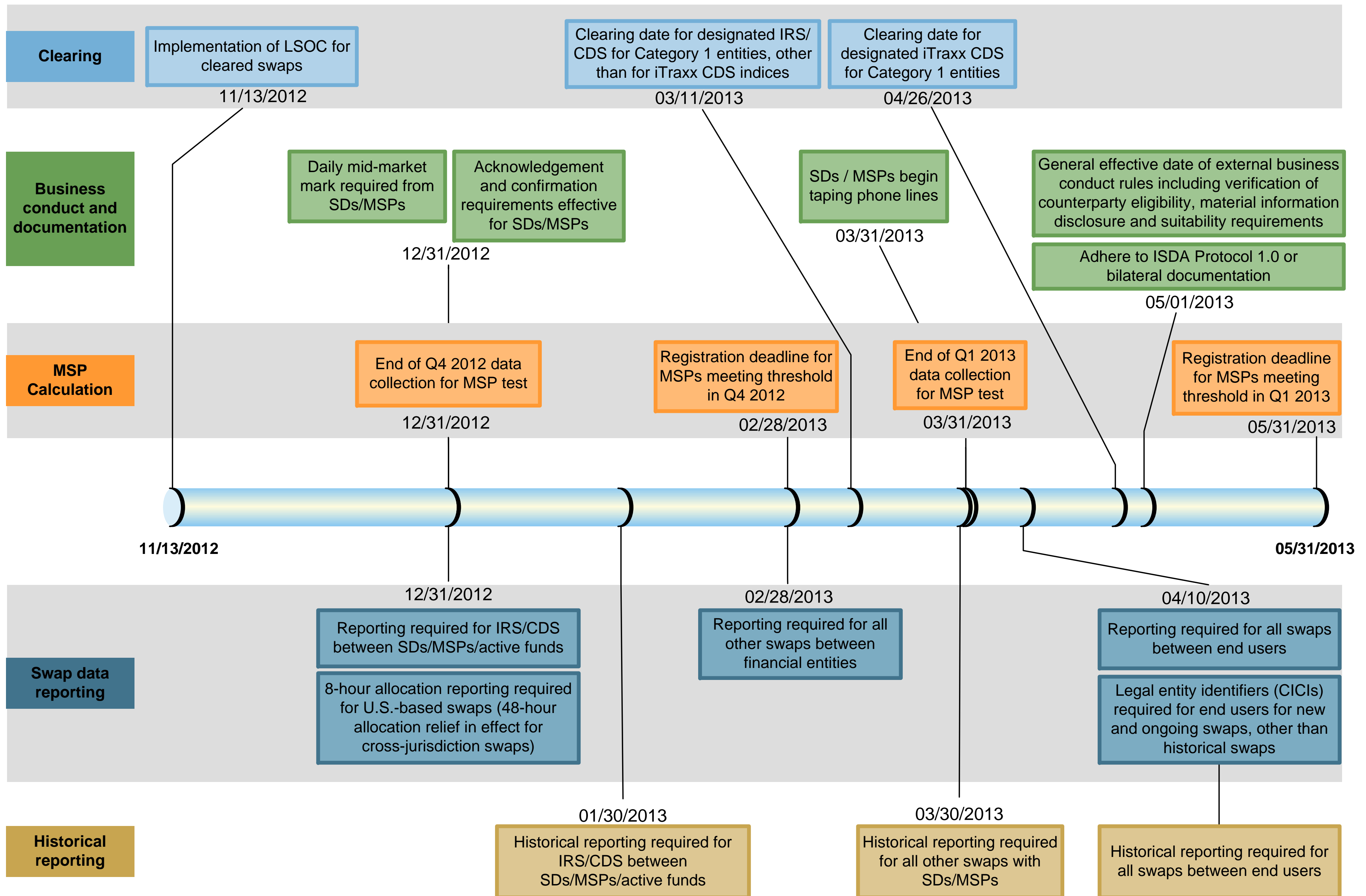
# Summary 2013 Dodd-Frank Swap Compliance Timeline for Asset Managers
Through May 2013

**Appendix A**

**As of March 11, 2013**

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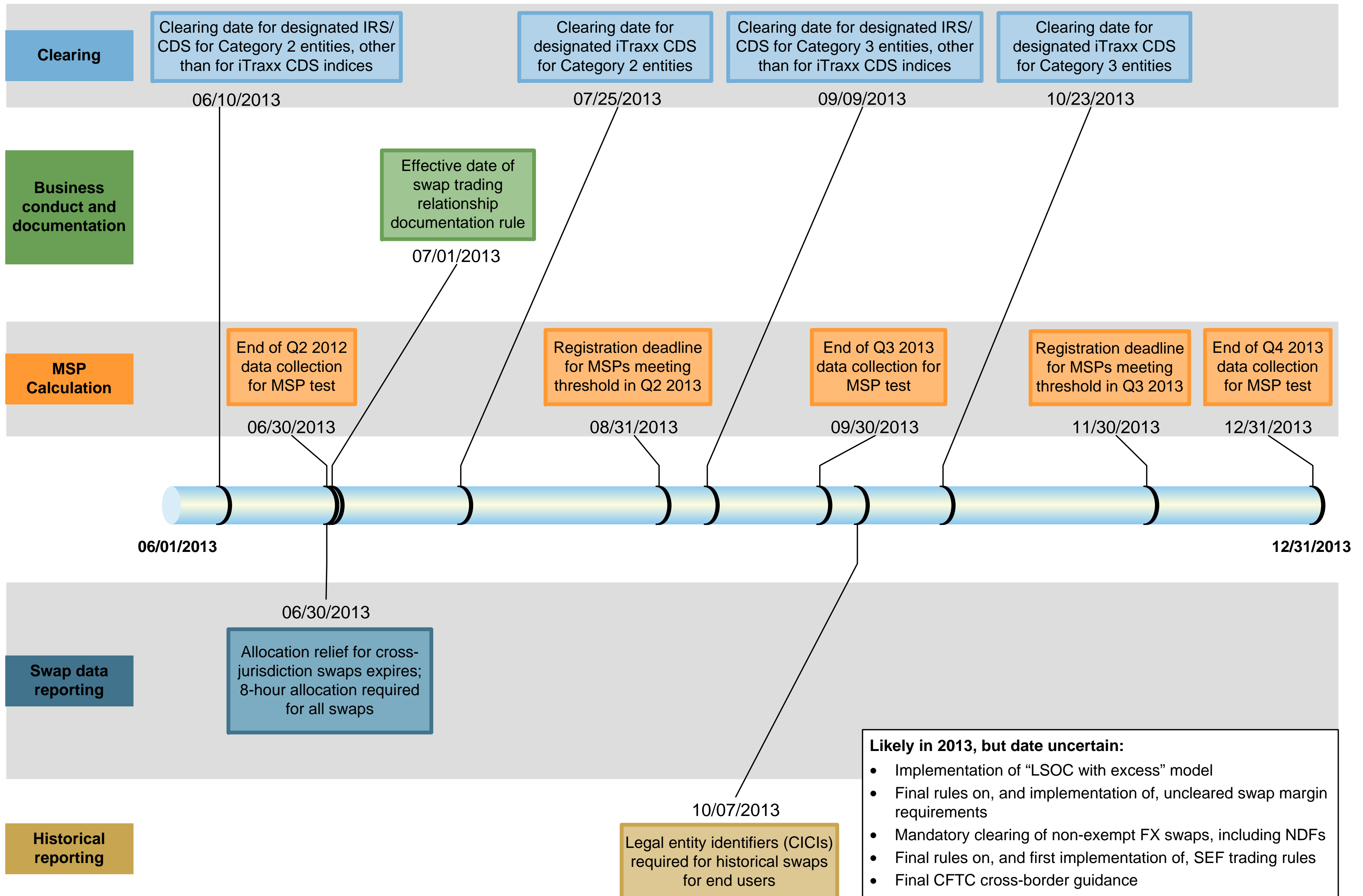
# Summary 2013 Dodd-Frank Swap Compliance Timeline for Asset Managers

June – December 2013

**Appendix A**

**As of March 11, 2013**

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# Timeframe for Reporting Primary Economic Terms (PET) and Confirmation Data – SD/MSP Reporting Counterparties

**The swap data reporting rule requires reporting counterparties to report PET and confirmation data for off-facility swaps as soon as technologically practicable following execution or confirmation, but not later than the specified reporting windows below.**

| SWAP CHARACTERISTICS | REPORTING WINDOWS* | | |
|---|---|---|---|
| | Year 1 | Year 2 | Year 3 and Thereafter |
| ***Subject to Mandatory Clearing*** | **PET:** 30 minutes<br>**Confirmation:** If confirmation occurs electronically: 30 minutes<br>Otherwise: 24 business hours | **PET:** 15 minutes<br>**Confirmation:** If confirmation occurs electronically: 30 minutes<br>Otherwise: 24 business hours | **PET:** 15 minutes<br>**Confirmation:** If confirmation occurs electronically: 30 minutes<br>Otherwise: 24 business hours |
| ***Not Subject to Mandatory Clearing — Non-reporting counterparty is SD/MSP or financial entity, or verification occurs electronically*** | **PET:** Credit, equity, foreign exchange and interest rate swaps: 1 hour<br>Other commodity swaps: 4 hours<br>**Confirmation:** If confirmation occurs electronically: 30 minutes<br>Otherwise: 24 business hours | **PET:** Credit, equity, foreign exchange and interest rate swaps: 30 minutes<br>Other commodity swaps: 2 hours<br>**Confirmation:** If confirmation occurs electronically: 30 minutes<br>Otherwise: 24 business hours | **PET:** Credit, equity, foreign exchange and interest rate swaps: 30 minutes<br>Other commodity swaps: 2 hours<br>**Confirmation:** If confirmation occurs electronically: 30 minutes<br>Otherwise: 24 business hours |
| ***Not Subject to Mandatory Clearing — Other*** | **PET:** Credit, equity, foreign exchange and interest rate swaps: 24 business hours<br>Other commodity swaps: 48 business hours**<br>**Confirmation:** If confirmation occurs electronically: 30 minutes<br>Otherwise: 24 business hours | **PET:** Credit, equity, foreign exchange and interest rate swaps: 12 business hours<br>Other commodity swaps: 24 business hours**<br>**Confirmation:** If confirmation occurs electronically: 30 minutes<br>Otherwise: 24 business hours | **PET:** Credit, equity, foreign exchange and interest rate swaps: 30 minutes<br>Other commodity swaps: 2 hours**<br>**Confirmation:** If confirmation occurs electronically: 30 minutes<br>Otherwise: 24 business hours |

* Reporting windows are measured from the execution or confirmation of the swap for PET data and confirmation data, respectively. Years are measured from the Compliance Date.

** A flowchart in the CFTC final release sets forth reporting windows that differ from the reporting windows provided in the final rule text. The appendices to this Client Memorandum are based on the final rule text.

## Timeframe for Reporting PET and Confirmation Data – Non-SD/MSP Reporting Counterparties

**The swap data reporting rule requires reporting counterparties to report PET and confirmation data for off-facility swaps as soon as technologically practicable following execution or confirmation, but not later than the specified reporting windows below.**

| SWAP CHARACTERISTICS | REPORTING WINDOWS* | | |
|---|---|---|---|
| | Year 1 | Year 2 | Year 3 and Thereafter |
| ***Subject to Mandatory Clearing*** | **PET:** 4 business hours<br>**Confirmation:** By the end of the second business day after confirmation | **PET:** 2 business hours<br>**Confirmation:** By the end of the first business day after confirmation | **PET:** 1 business hour<br>**Confirmation:** By the end of the first business day after confirmation |
| ***Not Subject to Mandatory Clearing*** | **PET:** 48 business hours<br>**Confirmation:** 48 business hours | **PET:** 36 business hours<br>**Confirmation:** 36 business hours | **PET:** 24 business hours<br>**Confirmation:** 24 business hours |

* Reporting windows are measured from the execution or confirmation of the swap for PET data and confirmation data, respectively. Years are measured from the Compliance Date.

# Enumerated Physical Commodity Contracts and Other Contracts

## Agriculture

- ICE Futures U.S. Cocoa
- ICE Futures U.S. Coffee C
- Chicago Board of Trade Corn
- ICE Futures U.S. Cotton No. 2
- ICE Futures U.S. FCOJ-A
- Chicago Mercantile Exchange Live Cattle
- Chicago Board of Trade Oats
- Chicago Board of Trade Rough Rice
- Chicago Board of Trade Soybeans
- Chicago Board of Trade Soybean Meal
- Chicago Board of Trade Soybean Oil
- ICE Futures U.S. Sugar No. 11
- ICE Futures U.S. Sugar No. 16
- Chicago Board of Trade Wheat
- Minneapolis Grain Exchange Hard Red Spring Wheat
- Kansas City Board of Trade Hard Winter Wheat
- Chicago Mercantile Exchange Class III Milk
- Chicago Mercantile Exchange Feeder Cattle
- Chicago Mercantile Exchange Lean Hogs

## Metals

- Commodity Exchange, Inc. Copper
- New York Mercantile Exchange Palladium
- New York Mercantile Exchange Platinum
- Commodity Exchange, Inc. Gold
- Commodity Exchange, Inc. Silver

## Energy

- New York Mercantile Exchange Light Sweet Crude Oil
- New York Mercantile Exchange New York Harbor Gasoline Blendstock
- New York Mercantile Exchange Henry Hub Natural Gas
- New York Mercantile Exchange New York Harbor Heating Oil

In addition, information regarding swaps that reference Brent Crude Oil (ICE) or that are economically related to Brent Crude Oil is not subject to public dissemination.

# Public Dissemination Delay for Block Trade / Large Notional Off-Facility Swap – At Least One SD/MSP Counterparty

**The real-time reporting rule provides the following time delays for block trades and large notional off-facility swaps. These time delays apply to all swaps or groups of swaps, regardless of size, until the CFTC establishes an appropriate minimum block size for a particular swap or group of swaps.**

| SWAP CHARACTERISTICS | TIME DELAYS FOR PUBLIC DISSEMINATION* | | |
|---|---|---|---|
| | Year 1 | Year 2 | Year 3 and Thereafter |
| ***Executed On or Pursuant to the Rules of a Registered SEF or DCM*** | 30 minutes | 15 minutes | 15 minutes |
| ***Off-Facility, Subject to Mandatory Clearing*** | 30 minutes | 15 minutes | 15 minutes |
| ***Off-Facility, Not Subject to Mandatory Clearing*** | Credit, equity, foreign exchange and interest rate swaps: 1 hour<br>Other commodity swaps: 4 hours | Credit, equity, foreign exchange and interest rate swaps: 30 minutes<br>Other commodity swaps: 2 hours | Credit, equity, foreign exchange and interest rate swaps: 30 minutes<br>Other commodity swaps: 2 hours |

* Delays are measured from the execution of the swap. Years are measured from the Compliance Date.

## Public Dissemination Delay for Block Trade / Large Notional Off-Facility Swap – No SD/MSP Counterparty

**The real-time reporting rule provides the following time delays for block trades and large notional off-facility swaps. These time delays apply to all swaps or groups of swaps, regardless of size, until the CFTC establishes an appropriate minimum block size for a particular swap or group of swaps.**

| SWAP CHARACTERISTICS | TIME DELAYS FOR PUBLIC DISSEMINATION* | | |
|---|---|---|---|
| | Year 1 | Year 2 | Year 3 and Thereafter |
| ***Executed On or Pursuant to the Rules of a Registered SEF or DCM*** | 30 minutes | 15 minutes | 15 minutes |
| ***Off-Facility, Subject to Mandatory Clearing*** | 4 hours | 2 hours | 1 hour |
| ***Off-Facility, Not Subject to Mandatory Clearing*** | 48 business hours | 36 business hours | 24 business hours |

* Delays are measured from the execution of the swap. Years are measured from the Compliance Date.