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CFTC Issues Final Rules on Confirmation, Portfolio Reconciliation, Portfolio Compression and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants



On August 27, 2012, the Commodity Futures Trading Commission (the “CFTC”) unanimously approved final rules (the “Final Rules”) that establish requirements for the (i) documenting of swap trading relationships between swap dealers (“SD”) or major swap participants (“MSP”) and their counterparties, (ii) timely and accurate confirmation of swaps and (iii) reconciliation and compression of swap portfolios. The Final Rules also set out the documentation requirements for swaps with respect to which an end-user has elected to avail itself of the exception from mandatory clearing and delay, until January 1, 2013, compliance with certain requirements of the external business conduct rules.¹ The Final Rules adopt, with amendments, three separate notices of proposed rulemaking² (each separate proposed rulemaking is, and the proposed rules collectively are, referred to herein as the “Proposed Rules”) and build upon the Federal Reserve Bank of New York’s efforts to improve back office standards of large financial institutions dealing in swaps. The CFTC perceives swap documentation as a critical aspect of the bilaterally-traded, over-the-counter derivatives market, and swap confirmation, portfolio reconciliation and portfolio compression as important post-trade mechanisms for reducing risk and improving operational efficiency.

The Final Rules do not apply retrospectively to swaps entered into prior to the date upon which compliance with the rules is required. The compliance dates for documentation, confirmation, portfolio compression and portfolio reconciliation are addressed in each relevant section below and in some instances are phased in.

Swap Trading Relationship Documentation (§23.504)

The Final Rules set forth a number of requirements with respect to swap trading relationship documentation and the contents thereof. The rules do not apply to (i) swaps executed on a designated contract market (“DCM”) or swaps executed anonymously on a swap execution facility (“SEF”), provided that such swaps are cleared by a derivatives clearing organization (“DCO”) and all terms of the swaps conform to the rules of the relevant DCO and §39.12(b)(6) of the CFTC’s regulations³ and (ii) swaps cleared by a DCO. As noted above, the Final Rules do not apply to swaps entered into prior to the relevant date of compliance with the Final Rules.

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¹ 77 FR 55904, September 11, 2012. The Final Rules add §§23.500 through 23.505.

² 75 FR 81519 (Dec. 28, 2010) (Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants (Confirmation NPRM)); 76 FR 6715 (Feb. 8, 2011) (Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants (Documentation NPRM)); and 76 FR 6708 (Feb. 8, 2011) (Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants (Orderly Liquidation NPRM)).

³ §39.12(b)(6) requires that DCO rules are definitive and trump contradictory terms in the underlying swap as executed between a SD/MSP and its counterparty.

Policies and Procedures

The Final Rules require SDs and MSPs to establish, maintain, and follow written policies and procedures reasonably designed to ensure that the SD/MSP executes written swap trading relationship documentation with its counterparty (such documentation to comply with the relevant sections of the Final Rules). These policies and procedures must be approved in writing by senior management of the relevant SD/MSP, and a record of the approval must be kept.

Documentation Requirements

The Final Rules require SDs/MSPs to execute swap trading relationship documentation prior to or contemporaneously with entering into a swap transaction with any counterparty. In order to address a contradiction that commentators highlighted with respect to the Proposed Rules, the Final Rules carve out confirmations from the requirement that documentation be executed prior to or contemporaneously with entry into a swap. The issue arose because the term “swap trading relationship documentation” was defined in the Proposed Rules to include confirmations (and “swap trading relationship documentation” is defined to include confirmations in the Final Rules also); however, confirmations are a post-trade requirement, and the Final Rules make this distinction clear.

We note that there is no exemption from the requirement to enter into swap trading relationship documentation for swaps between affiliates.

The Final Rules require swap trading relationship documentation to be in writing and include all terms governing the trading relationship between the SD/MSP and its counterparty, including, without limitation, terms addressing (i) payment obligations, (ii) netting of payments, (iii) events of default or other termination events, (iv) calculation and netting of obligations upon termination, (v) transfer of rights and obligations, (vi) governing law, (vii) valuation and (viii) dispute resolution procedures.

The Final Rules also require that the swap trading relationship documentation include certain specified details of the credit support arrangements of the parties. Specifically, such documentation must contain details of the following (as applicable): (i) initial and variation margin requirements, (ii) the types of assets that can be used as margin and any applicable haircuts, (iii) investment and rehypothecation terms for assets used as margin for uncleared

swaps and (iv) custodial arrangements for posted collateral, including whether margin assets are to be segregated with an independent third party.

The Final Rules require that swap trading relationship documentation between SDs/MSPs and another SD/MSP or a Financial Entity⁴ (or any other non-financial end user counterparty, if so requested by such other counterparty) must include written documentation in which the parties agree on the process (which may include any agreed upon methods, procedures, rules and inputs) for determining the value of each swap at any time from execution to the termination, maturity or expiration of such swap. The rules also state that to the maximum extent practicable, the valuation of each swap shall be based on recently-executed transactions, valuations provided by independent third parties or other objective criteria. The documentation that relates to valuation should include either (A) alternative valuation methods in the event of the unavailability or other failure of any input required to value the swap, or (B) a valuation dispute resolution process. The rules note that no SD/MSP is required to disclose to its counterparty confidential, proprietary information about any model it may use to value a swap.

The CFTC removed a provision from the Proposed Rules that required that valuation documentation be stated with specificity sufficient to allow a SD/MSP, the CFTC and any prudential regulator to value the swap independently in a substantially comparable manner. Commentators had raised concerns that this requirement could be read as requiring disclosure of proprietary information. The CFTC also removed the requirement that swap trading relationship documentation include certain items upon acceptance of the swap for clearing. Instead, all that is required is a statement in the documentation that, upon acceptance of a swap by a DCO: (i) the original swap is extinguished, (ii) the original swap is replaced by equal and opposite swaps with the DCO and (iii) all terms of the swap shall conform to the product specifications of the cleared swap established under the DCO's rules.

Audit: The Proposed Rules required SDs/MSPs, on an annual basis, to have an independent audit of at least 5 percent of the swap trading relationship documentation created during the previous 12-month period. This requirement has been replaced in the Final Rules with a requirement that SDs/MSPs obtain periodic independent audits sufficient to identify any material weakness in its documentation policies and procedures. A record of the results of each audit must be retained.

⁴ Defined as a counterparty that is not a swap dealer or a major swap participant and that is one of the following: (1) a commodity pool as defined in section 1a(5) of the Commodity Exchange Act (“CEA”), (2) a private fund as defined in section 202(a) of the Investment Advisers Act of 1940, (3) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974, (4) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956, and (5) a security-based swap dealer or a major security-based swap participant.

Recordkeeping: SDs/MSPs must keep all swap trading relationship documentation and make such documentation available to the CFTC, the Securities Exchange Commission (the "SEC"), as applicable, or any prudential regulator, promptly upon request.

Compliance

Compliance with the swap trading relationship documentation requirements is subject to phased-in timing depending on the type of counterparty the SD/MSP faces.

- Compliance is required by January 1, 2013 if the SD/MSP faces any of the following: SDs, security-based swap dealers, MSPs, major security-based swap participants, or an active fund.⁵
- Compliance is required by April 1, 2013 if the SD/MSP faces: a commodity pool, a private fund as defined in section 202(a) of the Investment Advisers Act of 1940 other than an active fund, or a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956.
- Compliance required by July 1, 2013 for swap transactions with any other counterparty.

End User Exception Documentation (§23.505)

SDs/MSPs that enter into a swap transaction with an end user claiming to be exempt from mandatory clearing must obtain documentation from the end user sufficient to provide a reasonable basis for believing that the counterparty satisfies the end user exception. In its guidance to the Final Rules, the CFTC stated that it is of the view that the "reasonable basis" standard does not require independent investigation of information or documentation provided by a counterparty electing the exception from mandatory clearing; so long as an SD/MSP has obtained information, documentation or a representation that on its face provides a reasonable basis to conclude that the counterparty qualifies for the end user exception, then, in the absence of facts that reasonably should have put the SD or MSP on notice that its counterparty may be ineligible for the exception, no further investigation would be necessary.

The documentation to be obtained by a SD/MSP in satisfaction of Part 23.505 must include: (i) the counterparty's identity, (ii) that the counterparty has elected not to clear a particular swap, (iii) that the counterparty is a non-financial entity, (iv) that the counterparty is hedging or mitigating a commercial risk, and (v) that the counterparty generally meets its financial obligations associated with non-cleared swaps. In respect of an end user that is reporting directly to an SDR how it generally expects to meet its financial obligations associated with uncleared swaps,⁶ only items (i) and (ii) above must be obtained by the SD/MSP and the SD/MSP must confirm that its counterparty has made the required annual submissions. SDs/MSPs must keep all documentation and make such documentation available to the CFTC, the SEC or any prudential regulator, promptly upon request.

Swap Confirmation (§23.501)

The obligations of a SD/MSP with respect to confirming swap transactions differs depending on the type of counterparty the SD/MSP faces and the prescribed timeframes are subject to a phase-in, which is discussed in more detail below. The CFTC has removed the requirements from the Proposed Rules that differentiated between swaps processed electronically and those that were not; the CFTC has also removed the requirement that certain swaps be confirmed within 15 minutes or 30 minutes of execution.

Facing a SD/MSP: Section 23.501 requires SDs/MSPs entering into swaps with another SD/MSP to execute a swap confirmation as soon as technologically practicable, but in any event by the end of first business day following the day of execution. Such requirement is subject to a phase-in period.

Facing non-SD/MSP counterparties: With respect to swaps entered into by a SD/MSP with a non-SD/MSP counterparty (which includes a Financial Entity), the SD/MSP must send an acknowledgment⁷ of the trade, rather than a confirmation, to its counterparty as soon as technologically practicable, but in any event by the end of the first business day following the day of execution.

5 Defined as a private fund, as defined in section 202(a) of the Investment Advisers Act of 1940, that is not a third-party subaccount and that executes 200 or more swaps per month based on a monthly average over the preceding 12 months. A "third party subaccount" is an account that is managed by an investment manager that (1) is independent of and unaffiliated with the account's beneficial owner or sponsor, and (2) requires approval by the beneficial owner of the account to execute documentation.

6 End users claiming relief under section 2(h)(7) must (i) not be a financial entity, (ii) be using the swap to hedge or mitigate commercial risk, and (iii) provide or cause to be provided to a SDR or, if no SDR is available, the CFTC, information about how the end user generally expects to meet its financial obligations associated with uncleared swaps.

7 An acknowledgment is defined as a written or electronic record of all of the terms of a swap. Once signed by the receiving counterparty, the acknowledgement becomes the confirmation.

The Final Rules require that SDs/MSPs shall have in place written procedures that require the SD/MSP, upon request by a prospective counterparty prior to execution of any swap, to furnish to the prospective counterparty prior to execution a draft acknowledgment specifying all terms of the swap transaction other than the applicable pricing and other relevant terms that are to be expressly agreed at execution. The Proposed Rules required that the SD/MSP send in all cases a draft acknowledgement prior to execution of a swap with a non-SD/MSP counterparty.

In addition to the requirement to send a post-trade acknowledgment, SDs/MSPs facing a counterparty that is neither a SD/MSP nor a Financial Entity must establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes a confirmation for each swap transaction with such counterparty as soon as technologically practicable but not later than the end of the first second day following the day of execution. Both requirements are subject to a phase-in period.

Facing a Financial Entity: As noted above, SDs/MSPs facing a Financial Entity must send a post-trade acknowledgment to its counterparty. In addition, SDs/MSPs facing a Financial Entity must establish, maintain and follow written policies and procedures reasonably designed to ensure that it executes a confirmation for each swap transaction that it enters into with a Financial Entity as soon as technologically practicable but not later than the end of the first business day following the day of execution. Such requirements are subject to a phase-in period.

A confirmation is created when an acknowledgment is manually, electronically or by some other legally equivalent means signed by the receiving counterparty. The Final Rules define a confirmation as the consummation (electronically or otherwise) of legally binding documentation (electronic or otherwise) that memorializes the agreement of the counterparties to all of the terms of a swap transaction. A confirmation must be in writing (whether electronic or otherwise) and must legally supersede any previous agreement.

In response to comments, the CFTC revised the Proposed Rules to state explicitly in the Final Rules that swaps executed on a SEF or DCM, and swaps cleared by a DCO, will be deemed to have met the confirmation requirements so long as: (i) confirmation of all terms of the transaction takes place at the same time as execution on a SEF or DCM⁸ or (ii) the parties submit the swap for clearing no later than the time that confirmation would otherwise be required and the DCO confirms the terms of the swap upon acceptance for clearing. To ensure that no swap transaction goes unconfirmed, the Final Rules contain a backstop requirement for

SDs/MSPs to confirm a swap for which the registrant receives notice that a SEF, DCM, or DCO has failed to provide a confirmation on the same day as it receives such notice.

Timing Issues

The CFTC has modified the Proposed Rules to adjust the confirmation deadline for swaps among SDs and MSPs and between SDs, MSPs and financial entities whenever the parties (i) execute a swap near the end of the trading day or (ii) execute a swap with a counterparty located in a different time zone. The CFTC was sensitive to the fact that the proposed confirmation deadlines may discourage trade execution late in the day. The Final Rules therefore provide as follows:

- To account for time-zone issues, the “day of execution” has been defined to be the calendar day of the party to the swap that ends latest.
- To account for end-of-day trading issues, the definition of “day of execution” deems such day to be the next succeeding business day if execution occurs after 4:00 p.m. in the place of either counterparty.
- To account for non-business day trading, the “day of execution” is also deemed to be the next succeeding business day if execution occurs on a day that is not a business day.

Allocation of Block Trades

The Proposed Rules did not address confirmation in the context of block trades that must be allocated prior to confirmation. The Final Rules also do not address this issue specifically—the CFTC noted that the confirmation requirements allow SD/MSPs and the asset managers for their counterparties the flexibility to work out an efficient and timely allocation process within the deadlines for confirmation as required by the Final Rules.

Ownership Modifications

The Final Rules require SDs and MSPs to comply with the confirmation requirements for all “swap transactions.” Given the definition of “swap transaction,”⁹ this will require confirmation of changes to the terms of a swap or changes to the ownership of a swap. Confirmation of events that may impact the economics of the swap is not required. We note that the CFTC believes that, to the extent that the documented terms of a swap are agreed to in advance and provide for automatic changes to terms upon the occurrence of a defined event, such change would not require confirmation.

⁸ If a SEF or DCM does not provide confirmation services, the confirmation deadlines of the rule will control.

⁹ “Swap transaction” is defined as any event that results in a new swap or in a change to the terms of a swap, including execution, termination, assignment, novation, exchange, transfer, amendment, conveyance, or extinguishing of rights or obligations of a swap.

Phased Compliance—Swaps with SD/MSP counterparties

Commencing on the effective date of the Final Rules,¹⁰ compliance is subject to a phase-in period depending on the type of counterparty and product that is the subject of the transaction. Swap transactions between SDs/MSPs must be confirmed as soon as technologically practicable, but in any event:

- For credit swap/interest rate swaps, by (A) the end of the second business day following the day of execution for swaps entered into on or before February 28, 2014; and (B) the end of the first business day following the day of execution for swaps entered into on or after March 1, 2014.
- For equity swaps, foreign exchange swaps, or other commodity swaps, by (A) the end of the third business day following the day of execution for swaps entered into on or before August 31, 2013; (B) the end of the second business day following the day of execution for swaps entered into between September 1, 2013 and August 31, 2014; and (C) the end of the first business day following the day of execution for swaps entered into after September 1, 2014.

Phased Compliance—Acknowledging swaps with non-SD/MSP counterparties (including Financial Entities)

An acknowledgment must be sent as soon as technologically practicable, but in any event by:

- For credit swaps/interest rate swaps: (A) the end of the second business day following the day of execution for swaps entered into on or before February 28, 2014; and (B) the end of the first business day following the day of execution for swaps entered into after March 1, 2014.
- For equity swaps, foreign exchange swaps or other commodity swaps: (A) the end of the third business day following the day of execution for swaps entered into on or before August 31, 2013; (B) the end of the second business day following the day of execution for swaps entered into between September 1, 2013 and August 31, 2014; and (C) the end of the first business day following the day of execution for swaps entered into from September 1, 2014.

Phased Compliance—Confirming swaps with non-SD/MSP counterparties (excluding Financial Entities)

SDs/MSPs must have policies and procedures in place reasonably designed to ensure that the SD/MSP executes a confirmation:

- For credit swaps or interest rate swaps, not later than (A) the end of the fifth business day following the day of execution for swaps entered into on or before August 31, 2013; (B) the end of the third business day following the day of execution for the

period from September 1, 2013 to August 31, 2014; and (C) the end of the second business following the day of execution from and after September 1, 2014.

- For equity swaps, foreign exchange swaps, or other commodity swaps not later than (A) the end of the seventh business day following the day of execution for swaps entered into on or before August 31, 2013; (B) the end of the fourth business day following the day of execution for the period from September 1, 2013 to August 31, 2014; and (C) the end of the second business following the day of execution from and after September 1, 2014.

Phased Compliance—Confirming swaps with Financial Entities

SDs/MSPs must have policies and procedures in place reasonably designed to ensure that the SD/MSP executes a confirmation as soon as technologically practicable but in any event:

- for credit swaps or interest rate swaps by (A) the end of the second business day following the day of execution for swaps entered into on or before February 28, 2014; and (B) the end of the first business day following the day of execution from and after March 1, 2014.
- for equity swaps, foreign exchange swaps, or other commodity swaps, by the end of the third business day following the day of execution swaps entered into on or before August 31, 2013; (B) the end of the second business day following the day of execution for the period from September 1, 2013 to August 31, 2014; and (C) the end of the first business day following the day of execution from and after September 1, 2014.

Recordkeeping Requirements

SDs/MSPs are required to make and retain a record of: (i) the date and time of transmission to, or receipt from, a counterparty of any acknowledgment; and (ii) the date and time of transmission to, or receipt from, a counterparty of any confirmation. All such records must be retained and made available promptly upon request to the CFTC, any applicable prudential regulator, or the SEC.¹¹

Portfolio Reconciliation (§23.502)

The Final Rules require periodic swap portfolio reconciliation of uncleared swaps when both counterparties are SDs/MSPs. Portfolio reconciliation may be performed on a bilateral basis by the counterparties or by a qualified third party. Specifically, in respect of swaps between SDs and MSPs, portfolio reconciliation must be performed (a) at least each business day for swap portfolios with 500 or more swaps on any business day, (b) at least once a week

¹⁰ The effective date is November 13, 2012 which is 60 days following publication in the Federal Register.

for swap portfolios with between 50 and 500 swaps on any business day, and (c) at least quarterly for swap portfolios with no more than 50 swaps during a calendar quarter. As between SDs/MSPs, the parties must agree in writing on the terms of the portfolio reconciliation.

In addition, SDs/MSPs must establish, maintain, and follow written policies and procedures reasonably designed to ensure that it engages in portfolio reconciliation with non-SD/MSP counterparties as follows: (i) at least quarterly with any counterparty with which the SD/MSP has more than 100 swaps in a calendar quarter, and (ii) at least annually for all other counterparties.

With respect to all portfolio reconciliation, written policies must be in place that are designed to ensure that valuation disputes that arise during reconciliation or otherwise are resolved as soon as possible but in any event within five business days. The Final Rules contain a safe harbor for valuation discrepancies where the discrepancy between the highest valuation and lowest valuation is less than ten percent; such difference will be deemed not to be a discrepancy.

Dispute Resolution: The Proposed Rules required SDs and MSPs to notify the CFTC and any applicable prudential regulator and the SEC¹² of any swap valuation dispute not resolved within one business day, for a dispute with a SD/MSP, or within five business days for a dispute with any other counterparty. The CFTC has modified this requirement in the Final Rules to provide that (i) only swap valuation disputes in excess of US\$20 million (or its equivalent in any other currency) must be reported and (ii) a dispute must be outstanding for three business days between SDs/MSPs before it is reportable. Disputes with other counterparties are reportable if not resolved after five business days.

Compliance: SDs/MSPs that are currently regulated by a prudential regulator or that are registered with the SEC must comply with the portfolio reconciliation rules by the date that is 90 days after publication of the Final Rules in the Federal Register.¹³ SDs/MSPs that are not currently regulated by a prudential regulator and are not SEC registered must comply by the date that is 180 days after publication of the Final Rules in the Federal Register.

Portfolio Compression (§23.503)

The CFTC removed the requirement from the Proposed Rules that SDs/MSPs engage in bilateral and multilateral portfolio compression with all swaps where their counterparty is a SD/MSP. The Final Rules require SDs/MSPs to establish policies and procedures for periodic portfolio compression. With respect to swaps with SDs and MSPs, each SD and MSP must implement written procedures for terminating each fully offsetting swap in a timely fashion, for periodically engaging in bilateral portfolio compression exercises, and for periodically engaging in multilateral portfolio compression exercises. The policies must provide for participation in multilateral portfolio compression exercises as mandated by the CFTC regulation or order, and the evaluation of multilateral portfolio compression initiated, offered or sponsored by third parties. With respect to swaps with non-SDs and non-MSPs, an SD/MSP must have written procedures for periodically terminating fully offsetting swaps and engaging in portfolio compression exercises to the extent requested by any such counterparty. Portfolio compression requirements do not apply to swaps cleared by a DCO.

SDs/MSPs are required to maintain complete and accurate records of each bilateral offset and each bilateral or multilateral portfolio compression exercise in which it participates. All such records must be made available promptly upon request to the CFTC, or any applicable prudential regulator, or with regard to swaps defined in section 1a(47)(A)(v) of the CEA, to the SEC.

Compliance: SDs/MSPs that are currently regulated by a prudential regulator or that are registered with the SEC must comply with the portfolio compressions rules by the date that is 90 days after publication of the Final Rules in the Federal Register.¹⁴ SDs/MSPs that are not currently regulated by a prudential regulator and are not SEC registered must comply by the date that is 180 days after publication of the Final Rules in the Federal Register.

¹¹ With regard to swaps defined in section 1a(47)(A)(v) of the CEA.

¹² With regard to swaps defined in section 1a(47)(A)(v) of the CEA.

¹³ The compliance date is November 13, 2012 which is 60 days following publication in the Federal Register.

¹⁴ The effective date is November 13, 2012 which is 60 days following publication in the Federal Register. 377 FR 30596, May 23, 2012

Compliance Date Extension for Certain External Business Conduct Rules

In the guidance accompanying the Final Rules, the CFTC also addressed the external business conduct rules and delayed the compliance with certain requirements of those rules until January 1, 2013. The relevant sections that are subject to delayed compliance are: §§23.402; 23.410(c); 23.430; 23.431(a)-(c); 23.432; 23.434(a)(2), (b) and (c); 23.440 and 23.450. The compliance date for the balance of the other sections of the external business conduct rules remains unchanged and compliance is required by October 15, 2012 for such other sections.

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