

ClientAlert

Capital Markets/Derivatives

March 2011

CFTC Proposes Rules for Swap Trading Relationship Documentation

Overview

Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which was enacted on July 21, 2010, adds Section 4s(i) to the Commodity Exchange Act ("CEA"), which requires each registered swap dealer (an "SD") and major swap participant (an "MSP") to conform with standards as may be prescribed by the Commodity Futures Trading Commission (the "CFTC") for the timely and accurate confirmation, processing, netting, documentation and valuation of swaps. The stated aim is to, among other things, increase the standardization of swap documentation in order to facilitate central clearing, automated processing and swap reporting, increase market liquidity, improve valuation and risk management and reduce risk.

Accordingly, the CFTC has proposed rules to establish certain requirements for documenting the swap trading relationship between SDs, MSPs and their counterparties and for related recordkeeping and reporting obligations.¹ These rules for swap trading relationship documentation would effectively require SDs and MSPs to amend or change existing documentation with their counterparties when entering into new transactions.

Comments on the proposed rule must be submitted to the CFTC on or before April 11, 2011.

Proposed Rules on Swap Trading Relationship Documentation

Proposed Part 23.504 would require SDs and MSPs to "establish, maintain and enforce written policies and procedures" to ensure that the SD or MSP executes written swap trading relationship documentation, prior to or contemporaneously with entering into a swap transaction with a counterparty other than a derivatives clearing organization ("DCO"). The swap trading relationship documentation must include:

- All terms governing the trading relationship between the SD or MSP and its counterparty;
- All confirmations of swap transactions;
- Credit support arrangements, which shall contain:
 - initial and variation margin requirements;
 - types of assets that may be used as margin and asset valuation haircuts;



If you have questions or comments regarding this Client Alert, please contact:

Ian Cuillerier
Partner, New York
+ 1 212 819 8713
icuillerier@whitecase.com

Steven Ross
Counsel, New York
+ 1 212 819 8901
sross@whitecase.com

¹ CFTC Notice of Proposed Rulemaking, *Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants*, 76 FR 6715 (Feb. 8, 2011).

- investment and rehypothecation terms for assets used as margin for uncleared swaps; and
 - custodial arrangements for margin assets, including whether margin assets are to be segregated² with an independent third party; and
- Written agreement on the methods, procedures, rules and inputs (and any suitable alternative methods if any input should be unavailable or fail) for determining the value of each swap at any time so that independent valuation can be performed by the SD or MSP, counterparty and any applicable regulator.

The proposed rule also provides that, so long as the documentation requirements set forth above (including the independent valuation requirements) are satisfied, an SD or MSP is not required to disclose to the counterparty confidential, proprietary information about any model it may use internally to value a swap for its own purposes. It is however questionable how effective this provision will be in practice. Many swaps, particularly esoteric and novel swaps, are valued and priced based upon proprietary models. In order to comply with the requirements of the proposed rules it would seem that disclosure of these models will be necessary.

Another potential concern with the proposed rule is whether multiple “alternative methods” are required; the text of the provision suggests that more than one alternative method would indeed be required. It specifically states that “[s]uch methods, procedures and rules shall include alternative methods for determining the value of the swap.” In addition, it is uncertain whether the Loss Method under the 1992 ISDA Master Agreement and the Close-out Method under the 2002 ISDA Master Agreement satisfy the requirement to permit independent valuation. Finally, including the valuation methodology of a swap in the trading documentation would make it difficult for parties to update the proper valuation of a swap, if required. If a model is changed because the parties have adjusted factors and inputs in the valuation, the documentation would lag unless both parties agree to amend the applicable provisions of the contract. This could result in a situation where a recognized risk, which affects the value of a swap, is not reflected in the amount of collateral required to be posted.

Part 23.504 also requires prompt notification to the CFTC if any swap valuation dispute is not resolved within one (1) business day if each of the counterparties to the swap is an SD or MSP or within five (5) business days if one or both of the counterparties are not SDs or MSPs. Such time limitations could be burdensome in certain situations, such as in the case of frequent and rapid trading.

If an SD or MSP enters into a swap transaction that clears through a DCO, the swap trading relationship documents must include the following information:

- The date and time the swap was accepted for clearing;
- The name of the derivatives clearing organization;
- The name of the clearing member clearing for the SD or MSP;
- The name of the clearing member clearing for the counterparty, if known; and
- A statement that in accordance with the rules of the derivatives clearing organization:
 - The original swap is extinguished;
 - The original swap is replaced by equal and opposite swaps between clearing members and the derivatives clearing organization;
 - All terms of the cleared swap conform to templates established under the DCO’s rules; and
 - All terms of the swap, as carried on the books of the clearing member, conform to the terms of the cleared swap established under the DCO’s rules.

In addition, all policies and procedures for executing swap trading relationship documentation must be approved in writing by senior management of the SD or MSP and the record of such approval must be maintained. The proposed rule also requires that at least once each calendar year, an independent internal or external auditor shall examine no less than 5 percent of an SD’s or MSP’s required swap documentation to ensure compliance with the rule. All the required documentation must be maintained to be made available upon the request of any applicable regulator.

² The proposed rules work alongside the documentation requirements in previously proposed Part 23.601, which requires that the SD and MSP notify each counterparty of the counterparty’s right to elect for segregation of the collateral it supplies as initial margin and Part 23.602, which allows for the SD and MSP to agree in writing with the counterparty that variation margin may also be held in a segregated account. See CFTC Notice of Proposed Rulemaking, *Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy*, 75 FR 75432 (Dec. 3, 2010).

Another issue of concern is what effect the proposed rules will have on dormant swap trading relationships where swap documentation has been executed but no trades are presently in effect thereunder. The CFTC invites comment on whether a safe harbor for dormant trading relationships should be provided. In addition, the CFTC has suggested that SDs and MSPs maintain templates for the required documentation in order to move towards standardization of the documents relating to swap transactions.

Documentation Requirement Regarding the Authority of the Federal Deposit Insurance Corporation

The swap trading relationship documentation must also include a provision that acknowledges the transfer authority of the Federal Deposit Insurance Corporation ("FDIC") under sections 210(c)(9) and (10) of Title II of the Dodd-Frank Act.³ Title II grants to the FDIC the authority to restructure or liquidate systemically important financial companies in an orderly manner. The counterparties must acknowledge that in the event a counterparty is a "covered financial company"⁴ or an insured depository institution⁵ for which the FDIC has been appointed as a receiver (the "covered party"), the other counterparty may not "terminate, liquidate or net any swap solely by reason of the appointment of the FDIC as receiver" until 5 p.m. US eastern time on the business day following the appointment of the FDIC as receiver or after receiving notice that the swap has been transferred to a performing third party such as a bridge bank. The documentation must also provide that the counterparty that is not the covered party consents to any such transfer.

Proposed End-User Exception Documentation Rule

The proposed rule on swap trading relationship documentation addresses certain interrelated issues with the end-user clearing exception. Proposed Part 23.505 would require each SD and MSP to "obtain documentation sufficient to provide a reasonable basis on which to believe that its counterparty meets the statutory conditions required for an exception from a mandatory clearing requirement" and maintain all such documentation to make available upon the request of any applicable regulator. Such documentation shall include: (i) the identity of the counterparty; (ii) that the counterparty has elected not to clear a particular swap; (iii) that the counterparty is a nonfinancial 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.

This provision seems to shift the burden (or at least that it be shared) from the counterparty to the SD or MSP as it requires an SD or MSP to make determinations that the counterparty itself is better situated to make—namely, whether the counterparty is hedging commercial risk and whether it is an MSP can meet its obligations associated with the swap transactions. What constitutes a "reasonable basis" is unclear; as the rule would require obtaining documentation, it would seem that "reasonable basis" requires something more than representations from the counterparty.

Compliance Period

The proposed rules would effectively require SDs and MSPs to change or amend existing swap documentation with each counterparty when entering into new transactions to include any additional terms required by the proposed rules. Amending existing documents introduces a new burden and the CFTC has yet to establish the period by which swap documentation should comply with the proposed rules.

³ CFTC Notice of Proposed Rulemaking, *Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants*, 76 FR 6708 (Feb. 8, 2011). Comments on this proposed rule must also be submitted to the CFTC on or before April 11, 2011.

⁴ A "covered financial party" is defined in section 201(a)(8) of the Dodd-Frank Act as "(A) a financial company for which a determination has been made under section 203(b); and (B) does not include an insured depository institution." Under Section 203(b), the Secretary of the Treasury, upon the recommendation of the FDIC and Board of Governors, may make a determination to appoint the FDIC as the receiver to wind down the affairs of a financial company whose default may pose a systemic risk to the financial stability in the United States.

⁵ An "insured depository institution" is defined in 12 U.S.C. 1813 to be "any bank or savings association the deposits of which are insured by the [FDIC] pursuant to this chapter" and the term "includes any uninsured branch or agency of a foreign bank or a commercial lending company owned or controlled by a foreign bank for purposes of [12 U.S.C. 1818]."

This Client Alert is provided for your convenience and does not constitute legal advice. It is prepared for the general information of our clients and other interested persons. This Client Alert should not be acted upon in any specific situation without appropriate legal advice and it may include links to websites other than the White & Case website.

White & Case has no responsibility for any websites other than its own and does not endorse the information, content, presentation or accuracy, or make any warranty, express or implied, regarding any other website.

This Client Alert is protected by copyright. Material appearing herein may be reproduced or translated with appropriate credit.