

Key Title VII Implications of Dodd-Frank for Swaps and Derivatives Activities

Navigating Legal Challenges for Funds, End-Users and Other Buyers

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Key Implications of Title VII of Dodd-Frank for Swaps and Derivatives Activities:

September 25, 2013

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Context / Progress

- A. Dodd-Frank – July 21, 2010 – Title VII covers swaps
- B. Objective – reduce risk, increase transparency and promote market integrity in swap market
- C. Establishes requirements for:
 1. Clearing and trade execution
 2. Recordkeeping and Reporting
 3. SDs and MSPs including external business conduct rules

Context / Progress (cont.)

D. Jurisdictional Responsibility

1. SEC – security based swaps – Swaps on single equity, narrow index, loan
2. CFTC – swaps – interest rate, currency, commodity
3. Mixed Swaps – Both CFTC and SEC
4. Exclusions from “swap” include Insurance Products, Forward Contracts, Loan Participations

Context / Progress (cont.)

- E. Implementation to date – Final Rules and Orders; Proposed Rules; Interpretative/No-Action Letters – CFTC and SEC
- F. Certain Terms:
 1. ECP – Eligible Contract Participant
 2. DCO – Derivatives Clearing Organization
 3. MSP – Major Swap Participant
 4. SD – Swap Dealer
 5. SDR – Swap Data Repository
 6. SEF – Swap Execution Facility

Context / Progress (cont.)

7. Financial Entity – SD, MSP, commodity pool, private fund, employee benefit plan, person predominately engaged in activities in business of banking or financial in nature – e.g. hedge funds, money fund, treasury affiliates of end-users, securitization vehicles

Clearing

- A. CEA §2(h)(1)(A) – Unlawful to engage in a swap without submitting the swap for clearing to a DCO if swap is required to be cleared
- B. Clearing Requirement Determinations
 1. Initiated by DCO or CFTC
 2. CFTC Process – Study, Proposal, Comment, Further Study, Final Determination, Effectiveness
 3. Not necessarily result in clearing if no DCO to clear

Clearing (cont.)

- C. When is a Clearing Determination Effective? – Final Rule on Implementation – July 30, 2012
1. Category 1 – SDs/MSPs; active funds – 90 days after publication in Federal Register
 2. Category 2 – other financial entities (other than ERISA plans) – 180 days
 3. Category “3” – Other – e.g. End-Users, ERISA plans – 270 days

II. Clearing (cont.)

D. Exclusions/Exemptions

1. Spot FX
2. FX Swaps/FX Forwards – Treasury Determination – November 20, 2012
 - a. exemption from clearing only
 - b. remain subject to recordkeeping, reporting, business conduct rules

E. What must be cleared today?

1. Interest Rate Swaps – Four broad categories
2. Credit Default Swaps – Two categories

II. Clearing (cont.)

3. Affirmative Specifications; Negative or "limiting" specifications; relevance, e.g. to securitization vehicles
 4. December 13, 2012 Final Clearing Determination results in Effective Dates of March 11, 2013 (Category 1); June 10, 2013 (Category 2); September 9, 2013 (Category 3)
- F. Other Common Categories – Currency Swaps, Non-Deliverable Forwards, Commodity Swaps

II. Clearing (cont.)

G. What is Clearing?

1. End Result – DCO is counterparty to Buyer
2. Buyer agrees and enters trade with SD (execution on SEF or DCM)
3. Trade submitted to DCO for clearing
4. If accepted, trade novated to DCO – Buyer faces DCO
5. DCO looks to FCM as guarantor
6. Stated Benefits – Minimal credit exposure to DCO (structural protections; segregation); portability; pricing
7. Stated Detriments – Initial and variation margin requirements, possible additional FCM margin requirements, subject to DCO rules

Clearing (cont.)

8. Documentation – Account agreement, clearing agreement, DCO rules
 9. End User may elect to clear even if clearing not required
- H. End User Exception – If requirements met, end user may elect not to clear. Election is on a swap by swap basis.
1. Eligibility - What is an end user?
 - a. Not a “financial entity”
 - b. However, each of
 - (1) Financial Entity Affiliate – acts solely as agent for non financial entity
 - (2) Captive Finance Companies – 90/90 test
 - (3) Small Bank
- deemed not to be a “financial entity” for purposes of election

Clearing (cont.)

2. Requirements

- a. Hedging or mitigating commercial risk
- b. Not used for speculation, investing or trading
- c. Reporting
 - (1) Content
 - (2) Frequency
 - (3) Responsibility for reporting

3. SEC Filers

- a. Board approval – appropriate committee requirement
- b. Specificity of approval
- c. Hedging policy

Clearing (cont.)

- I. Inter-Affiliate Exemption – "Inward-facing" Swaps –
 1. Both eligible affiliates must elect; swap by swap election
 2. Eligibility – Majority ownership interest
 3. Consolidated financial statements
 4. Centralized risk management program; written documentation
 5. Reporting to an SDR
 6. Anti-evasion

Clearing (cont.)

- J. Applicability – For End-User, Two Tier Analysis of Requirements May Be Required
 - 1. "Market-Facing" Swap with Third Party (e.g. SD)
 - 2. "Inward-Facing" – Swap with Affiliate
- K. Eligible Treasury Affiliates – CFTC Letter No. 13-22 – June 4, 2013
 - 1. Eligible Treasury Affiliate – Direct wholly owned subsidiary of non financial parent; majority of wholly and majority-owned affiliates of ultimate parent qualify as end-users; ETA is financial entity solely as a result of providing services that are financial in nature; no affiliation with SD, MSP, certain others

Clearing (cont.)

2. No enforcement action for failure to clear a swap that is required to be cleared if enumerated requirements are satisfied

L. To clear or not to clear – Some Factors to Consider

1. Great Unknown – Margin Requirements for Uncleared Swaps for End Users
2. Liquidity, Economics of Trade, Creditworthiness of Counterparty

Eligible Contract Participant

- A. Unlawful for any person, other than ECP, to enter into swap unless on a contract market
- B. ECP includes (i) commodity pools with total assets exceeding \$5 million that are operated by registered CTA; (ii) entities with more than \$10 million in total assets or more than \$1 million in net assets if hedging
- C. CFTC Letter No. 12-17 – October 12, 2012 – Any entity against which have recourse on a swap

Eligible Contract Participant (cont.)

(guarantor, joint obligor, general partner) must be ECP

D. Ways to Address – Exclusions from guarantees; keep well arrangements; posting collateral not subject to ECP requirement

Extraterritorial Application

- A. CEA §2(i) – Title VII not applicable to activities outside U.S. unless (i) direct and significant connection with activities in, or effect on, commerce of U.S. or (ii) contravene rules to prevent evasion of DF
- B. CFTC Interpretive Guidance – July 13, 2013
 1. “U.S. Person” – includes, but not limited to, entities organized within U.S. or with principal place of business in U.S.; collective investment vehicle majority owned by U.S. persons
 2. Transition rules to October 9, 2013
 3. Single entity approach re: branches and agencies
 4. SD/MSP Registration requirements
 5. Transaction Level Requirements
 6. Substituted Compliance

Business Conduct Rules – Transaction Level

- A. Applicable to Registered SDs and MSPs – But Buyer Needs to Be Aware.
- B. Business conduct
 - 1. Certain requirements became effective May 1, 2013
 - 2. Includes (i) enhanced know your counterparty requirements, (ii) prohibition on fraud, (iii) verification of counterparty eligibility, (iv) certain disclosures, (v) requirements for Special Entity counterparties
 - 3. Ways to comply with certain business conduct rules – ISDA August 2012 Protocol or Bi-lateral Agreement
 - 4. Exempt FX Transaction exempted from certain disclosure requirements (CFTC Letter No. 13-12, May 1, 2013)

Business Conduct Rules – Transaction Level (cont.)

C. Trading Relationship Documentation Requirements

1. Certain requirements effective July 1, 2013
2. Includes requirements regarding (i) swap confirmations, (ii) portfolio reconciliation, (iii) portfolio compression, (iv) swap trading relationship documentation and (v) end user exception documentation
3. Ways to comply – ISDA March 2013 Protocol or Bilateral Agreement

Reporting Requirements

A. Swaps entered on or after April 10, 2013 (17 CFR Part 45)

1. If Swap executed on SEF or DCM or cleared by DCO then SEF, DCM or DCO, as relevant, required to report to SDR
2. Off Facility Swaps – Reporting counterparty – determined by following hierarchy
 - a. SD
 - b. MSP
 - c. Financial entity that is a U.S. person
 - d. End-user
 - e. Generally entity in higher tier is reporting counterparty; in case of tie, parties need to agree; end user with non U.S. financial entity, end user reports

Reporting Requirements (cont.)

3. Creation Data – Upon execution report primary economic terms data (with minimum terms specified by CFTC from time to time); confirmation data
4. Continuation Data – includes changes to primary economic terms data; life cycle event data; state data; valuation data
5. Unique Swap identifier and Legal entity identifier (LEI) to be reported
6. End-user exception data, when applicable
7. Required timing for reporting varies depending on reporting party and whether subject swap is cleared

Reporting Requirements (cont.)

B. Historical Swaps (17 CFR Part 46)

1. A swap in existence during the period between July 21, 2010 (enactment of DF) and date on which full compliance with Parts 45 and 46 is required (i.e. April 10, 2013)
2. Reporting Counterparty – Same methodology as Part 45
3. Information to Report to SDR or CFTC
 - a. Swaps expired or terminated prior to April 25, 2011 – such information as in party's possession on or after October 14, 2010, in case of pre-enactment swap, or December 17, 2010, otherwise.
 - b. Swaps in existence on or after April 25, 2011 – minimum primary economic terms; LEI of reporting counterparty; LEI or internal identifier of other party; internal transactions identifier if uncleared – certain continuation data; if cleared no continuation data required

Reporting Requirements (cont.)

C. Fund Reporting – Form PF

1. Introduction
2. Reporting Entities
3. Reporting Requirements
4. Data Requirements
 - 4.1 Data Identification
 - 4.2 Data Verification
 - 4.3 Data Aggregation
5. Challenges
 - 5.1 Significant Undertaking
 - 5.2 Lack of precision
 - 5.3 Lack of conformity with similar forms

Reporting Requirements (cont.)

D. CFTC No Action Letters

1. Where reporting party is a non-SD/MSP that is a financial entity – report historical swaps by September 30, 2013 (CFTC Letter No. 13-10, April 9, 2013)
2. Where reporting party is a non-SD/MSP that is not a financial entity – subject to certain conditions, deadlines:
 - a. July 1, 2013 for interest rate and currency swaps (Id.);
 - b. August 19, 2013 for equity swaps, FX swaps and commodity swaps (Id.);
 - c. October 31, 2013 for historical swaps (Id.)

Reporting Requirements (cont.)

3. Uncleared intra-group swaps involving wholly-owned affiliates conditionally exempt from Part 45 and, when applicable, certain end user exception reporting requirements (CFTC Letter No. 13-09, April 5, 2013)
4. Uncleared Intra-group swaps involving majority-owned affiliates reporting required quarterly (Id.)

Recordkeeping Requirements

A. Swaps entered on or after April 10, 2013 (Part 45)

1. “Full, complete and systematic records” for each swap including, where relevant in case of non-SD/MSP, records demonstrating entitlement to end-user exception
2. Concept analogous to futures context, intentionally not defined

B. Historical Swaps (Part 46)

1. Required Records – Swaps in existence on or after April 25, 2011:
 - a. Minimum primary economic terms (specified, by type, by CFTC from time to time)
 - b. Any confirmation, master agreement, credit support agreement if in possession on or after April 25, 2011

Recordkeeping Requirements (cont.)

2. Required Records – Swaps that expired or terminated prior to April 25, 2011:
 - a. Entered pre-enactment – Info and documents relating to terms that were possessed on or after October 14, 2010
 - b. Entered post-enactment – Info and documents relating to terms that were possessed on or after December 17, 2010

C. Retention Period – Life of swap plus 5 years

D. Retrieval

1. SD/MSP – Part 45 – real time for life of swap plus 2 years; for remainder within 3 Business Days; Part 46 – within 3 Business Days
2. Non-SD/MSP – within 5 Business Days

Thank You.