ISDA Safe, Efficient Markets

Six Weeks To Go: Complying with the CFTC's External Business Conduct Rules

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Introduction

Outline of Presentation

I. What are the business conduct standards and why do they matter?

II. What does the DF Protocol do to address the business conduct standards?

III. What are the most significant provisions of the DF Protocol?

IV. What are the basic steps required to adhere?

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Business Conduct Standards

- The Business Conduct Standards are a new set of rules that basically work like a customer protection regime for the counterparties of Swap Dealers.
- Some of the new rules do not impact documentation, and the DF Protocol does not address them.
    - E.g., increased anti-fraud protection.
- Other rules do impact documentation, and if ISDAs are not modified prior to the time that Swap Dealers are required to be in compliance, then Swap Dealers would be at potentially significant regulatory risk.

Documentation Impacts and the DF Protocol

- Swap Dealers are required to obtain various types of information from their counterparties.
  - The DF Protocol provides for information exchange.
- Suitability rules require potentially intrusive diligence, unless a counterparty allows the Swap Dealer to be in a safe harbor.
  - The DF Protocol allows for safe harbor elections.
- Various notification and disclosure rules may affect timing for execution of trades.
  - The DF Protocol allows parties to agree on how these rules are applied in the context of a trading relationship.
- Certain of the rules are perceived to be difficult to comply with.
  - The DF protocol adjusts Swap Dealer responsibilities.

Documentation Impacts re: Special Entities

- The Business Conduct Standards impose additional very significant requirements on swap dealers in respect of their relationships with "Special Entities" (federal agencies, states, state agencies, cities, counties, governmental plans, employee benefit plans, endowments)
- Dealer must have a reasonable basis to believe that the Special Entity has a representative that is independent and knowledgeable
- Consequence if not: will cause dealer to "act as adviser" to the Special Entity
  - The DF Protocol allows for safe harbor elections, but unlike the other protocol solutions discussed previously these elections may have a significant operational or even commercial impact on dealers and Special Entities

Timing

- Dealers must comply with the EBC rules by May 1, 2013.
- Counterparties can potentially wait until May 1st to adhere and exchange questionnaires, but they will run risk of delays and possible disruption in trading activity.
- It will take some time – potentially several hours spread out over a several week period – to adhere and complete questionnaire, so counterparties should start working on this now.
- Markit has encouraged on-boarding to ISDA Amend no later than April 1, 2013, to ensure access to platform and ability to accept questionnaires prior to May 1.

Who is affected?

- Dodd-Frank Act applies to swap activities within the United States.
- Per Section 2(i) of the Commodity Exchange Act, the Dodd-Frank Act also applies to activities *outside* the United States that "*have a direct and significant connection with activities in, or effect on, commerce of the United States.*"
  - The CFTC proposed cross-border guidance in July 2012 in which it proposed a broad definition of "U.S. person" that would capture many non-U.S. entities (e.g., offshore hedge funds with U.S. nexus).
  - Pending the finalization of its cross-border guidance, the CFTC issued a final exemptive order providing temporary relief for swap dealers based on a narrower definition of U.S. person. This order expires on July 12, 2013.

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Who is affected?

- U.S. and foreign counterparties that trade with U.S. swap dealers.
- U.S. counterparties that trade with (i) foreign swap dealers registered with the CFTC and (ii) foreign branches of U.S. swap dealers.

DF Supplement - Representations

- Representations and Information. The provisions of Schedule 2 include (i) representations by CPs as to the accuracy of information provided and representations made, (ii) an agreement to update previous information and representations to maintain the accuracy thereof and (iii) an agreement to provide additional information.
  - Under the EBC Rules, SD/MSPs may reasonably rely on CP representations if the CP agrees to update representations in a timely manner and there are no “red flags”.
  - Additional information may be required under the Covered Rules (i) to satisfy swap reporting requirements and (ii) to satisfy a Swap Dealer’s “KYC” requirements to (a) comply with applicable laws, (b) implement the credit and operational risk management policies and (c) establish the authority of persons acting for the counterparty.
- Section 2.2 limits cross-defaults due to misrepresentation or breach of agreement under the DF Supplement.

DF Supplement - Confidentiality

Confidentiality

- EBC Rules impose new confidentiality requirements on swap dealers and MSPs.
- *Absent contrary agreement* or a regulatory safe harbor, Swap Dealers and MSPs are prohibited from:
    - ❖ disclosing confidential information to “any other person;” and
    - ❖ using confidential information in a way that would be materially adverse to the counterparty.

DF Supplement – Confidentiality (cont'd)

- Material Confidential Information (Sections 2.5, 2.14 & 2.15).
  - Parties agree to the disclosures required by the Covered Rules, such as to swap data repositories.
  - If parties have an existing non-disclosure agreement, such agreement will continue to govern the disclosure of material confidential information.
  - If parties do not have an existing non-disclosure agreement, material confidential information may be disclosed in accordance with the Covered Rules and the parties expressly agree that such information may be disclosed to (i) certain other parties to comply with the risk management policies of the parties, and (ii) "front office" employees for pricing and hedging purposes.

DF Supplement – Daily Marks and Scenario Analysis

- Daily Marks: Swap Dealers are obligated to provide a "mid-market" mark both prior to the trade and on a daily basis during the trade. The protocol clarifies that the dealer may base the daily mark on the previous day's close of business. In addition, counterparties are allowed to elect to receive the pre-trade mark orally (confirmed in writing).
- Scenario Analysis: Swap Dealers are obligated to provide a scenario analysis upon request. The protocol requires hedge funds to request any scenario analysis before the trade.

DF Supplement – Institutional Suitability

- Under the EBC Rules, an SD that “recommends” a swap or trading strategy involving a swap to a CP is subject to suitability requirements, including “reasonable diligence” by the SD to establish CP-specific suitability.
- <u>Safe Harbor</u>:
  - The CP or its agent represents that it is exercising independent judgment in evaluating recommendations.
  - SD must determine that the CP or its discretionary agent is capable of “independently” evaluating the investment risks of a swap.
  - This can be established through representations of CP and or its agent, BUT . . .
    - The CP must represent that it has complied in good faith with <u>written policies and procedures</u> reasonably designed to ensure that the persons responsible for evaluating recommendations and making trading decisions are capable of doing so.

DF Supplement – Special Entity Provisions

- Schedules 5 and 6 apply to Employee Benefit Plans. Schedule 4 applies to all other Special Entities. The safe harbor works differently with respect to these three Schedules as will be discussed on the next slide.
- The Employee Benefit Plan schedules are easier to deal with because such plans already have a fiduciary that is presumed to be independent and knowledgeable. The reps therefore mostly establish the existence of the fiduciary and that the fiduciary will be making decisions on swaps.
- Other Special Entities do not have a fiduciary. Schedule 4 requires the creation of a new “Qualified Independent Representative” (QIR) and requires reps from both the entity itself and its QIR as to its independence and knowledge, as well as reps relating to written policies and procedures on these matters.
- Special Entities, and in particular Schedule 4 Special Entities, will require additional work in adhering to the protocol and so should assess these provisions immediately.

Schedules 4, 5, and 6: Key Term Summary

	Representative	Opinions
Schedule 4: Non-ERISA	QIR	Not permitted
Schedule 5: ERISA	ERISA Fiduciary	Permitted if evaluated by the Fiduciary
Schedule 6: ERISA	ERISA Fiduciary	Not permitted

- Opinions -- CFTC Rule 23.440(b)(2)(i):

  "The swap dealer does not express an opinion as to whether the Special Entity should enter into a recommended swap or trading strategy involving a swap that is tailored to the particular needs or characteristics of the Special Entity"

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Architecture of the August 2012 Protocol

The August 2012 Protocol consists of the following six main components:

- Protocol Agreement: The main structural document.
- Adherence Letter: Evidences a party's agreement to be bound by the Protocol.
- Questionnaire: Allows a party to provide information about itself, make certain safe-harbor elections, and identify the counterparties with whom it is willing to apply DF Supplement provisions.
- Addendum 1: Contains additional optional reps relevant to counterparties not completed when the protocol was first launched.
- DF Supplement: Contains representations, covenants, disclosures, acknowledgements and notifications related to the Covered Rules that counterparties may apply to their swap trading relationship.
- DF Terms Agreement: Allows parties to apply selected provisions of the DF Supplement to their trading relationship in respect of swaps, whether or not they have an existing master swap agreement.

How to participate in the August 2012 Protocol

- Get a Cici from DTCC **www.ciciutility.org** ($200 per fund; credit card required)
- To participate in the ISDA August 2012 D-F Protocol a party must:
  - Deliver a completed and executed Adherence Letter to ISDA through the ISDA Protocol Management page, **http://www2.isda.org/functional-areas/protocol-management/protocol/8**
  - Deliver a completed and executed Questionnaire to its Swap Dealer counterparties. This can be done using ISDA Amend by Markit (**http://www.markit.com/en/products/distribution/counterparty-manager/isda-amend.page**), or by other means (including email).
- For most counterparties, each will need to adhere separately ($500 per fund; credit card required).
- If a party does not deliver a Questionnaire to one or more of its counterparties, the Protocol will have no effect on its swap documentation with such counterparties.

The Questionnaire

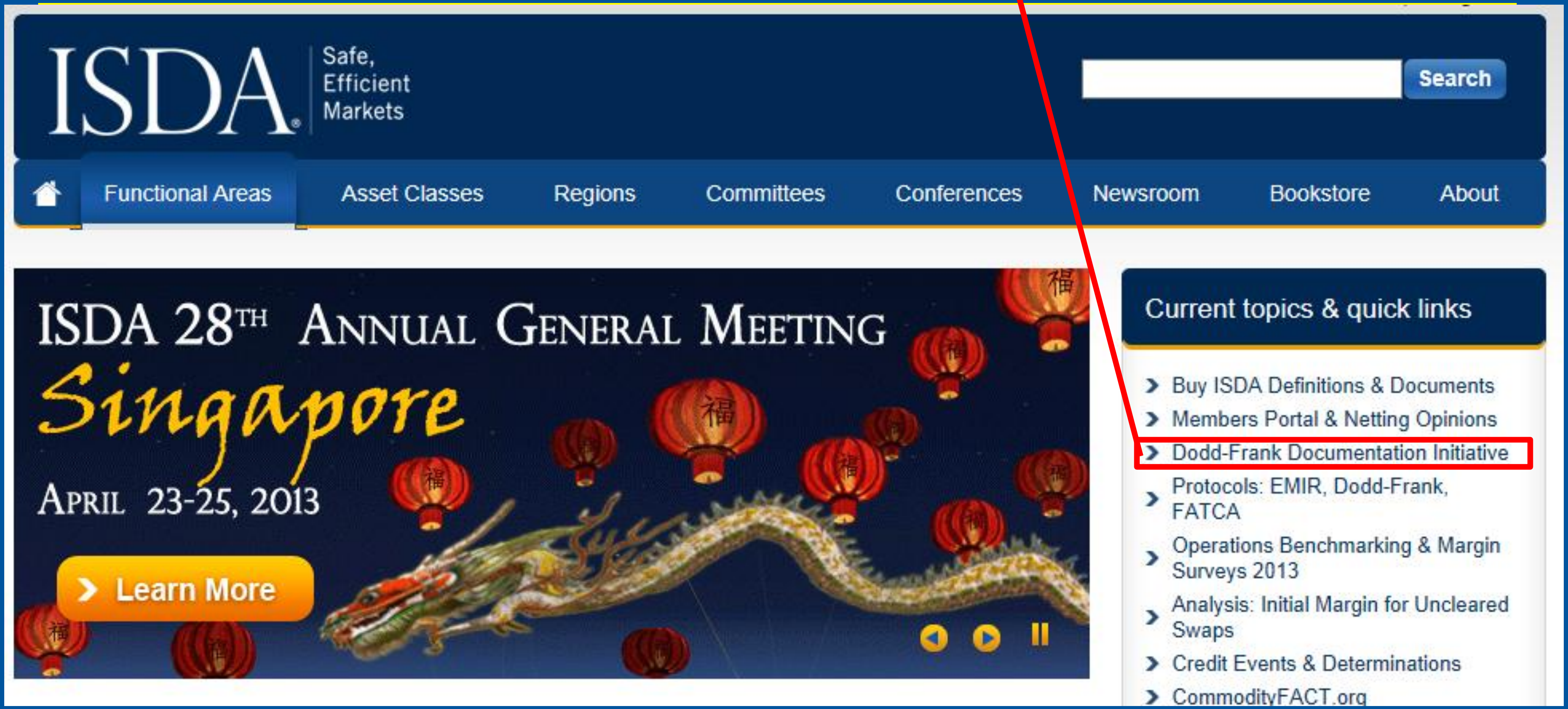
- Allows a participant to provide information required by the rules solely to the counterparties it chooses.
- Allows a participant to make certain elections, including
  - Incorporation of certain “suitability” safe harbor provisions of the DF Supplement.
  - Agreeing to receive pre-trade mid-market marks orally, and
  - Agreeing to incorporate the DF Terms Agreement.
- Under the Questionnaire, a participant is required to specify its legal status by identifying itself as a commodity pool, if applicable, and by specifying the manner in which it is an eligible contract participant.

The DF Terms Agreement

The DF Terms Agreement allows parties to apply selected provisions of the DF Supplement to their trading relationship in respect of swaps.

- Governs the parties' *relationship*, not the terms of the swaps.
- Available if parties have no existing master agreement governing swaps (*e.g.*, because they only execute swaps for prime brokerage, or only use long-form confirmations) or wish to apply the DF Supplement without supplementing existing master agreements.
- "Bare-bones" agreement that includes basic representations, governing law, address information and basic contract provisions.

Get started on www.isda.org



Download slides and all links and documents from this presentation

http://www2.isda.org/dodd-frank-documentation-initiative/