

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

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Derivatives Insight

On August 27, 2012, the CFTC approved final rules which 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 the effective date of certain requirements of the external business conduct rules until January 1, 2013.

Swap Trading Relationship Documentation (§23.504)

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 counterparties. Such policies and procedures must be approved in writing by senior management. Swap trading relationship documentation (other than confirmations) must be executed prior to or contemporaneously with entering into a swap transaction with any counterparty. There is no exemption from the requirement to enter into swap trading relationship documentation for swaps between affiliates.

Swap trading relationship documentation must 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 as well as certain specified details of the credit support arrangements of the parties. Swap trading relationship documentation between SDs/MSPs and another SD/MSP or a financial entity (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 Final Rules require SDs/MSPs to obtain periodic independent audits sufficient to identify any material weakness in its documentation policies and procedures and to notify the CFTC, the SEC (if applicable) and any prudential regulator of any swap valuation disputes in excess of \$20,000,000.

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

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. The documentation to be obtained by a SD/MSP 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, only items (i) and (ii) above must be obtained.

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.

Facing a SD/MSP or Financial Entity: SDs/MSPs entering into swaps with another SD/MSP must 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. SDs/MSP must have written policies and procedures reasonably designed to ensure compliance with its confirmation obligations.

Facing non-SD/MSP counterparties: With respect to swaps entered into by a SD/MSP with a non-SD/MSP counterparty, the SD/MSP must send an acknowledgment of the trade, rather than a confirmation, as soon as technologically practicable, but in any event by the end of the first business day following the day of execution. In addition, SDs/MSPs 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 counterparty that is not a SD/MSP or a financial entity not later than the end of the second business day following the day of execution.

Upon request by a prospective counterparty prior to execution of any swap, the SD/MSP must 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.

Compliance with the swap confirmation obligations is subject to a phase-in period depending on the type of counterparty the SD/MSP is facing and type of product. For swaps with another SD/MSP, the requirements to execute a confirmation by the end of the relevant business day do not commence until March 2014 (for credit swaps/interest rate swaps) or September 2014 (for other products). For swaps with non-SD/MSP counterparties, the timeframes described above are also gradually imposed with the most restrictive deadlines not coming into effect until March 2014 or September 2014, depending on the product.

Portfolio Reconciliation (§23.502) and Portfolio Compression (§23.503)

The Final Rules require periodic swap portfolio reconciliation of uncleared swaps. 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 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.

In addition, SD/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. Written policies must be in place to resolve any valuation discrepancy identified as part of the portfolio reconciliation procedures.

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. 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 if requested by such counterparty. Portfolio compression requirements do not apply to swaps cleared by a DCO.

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

Delayed compliance with External Business Conduct Rules

As part of the Final Rules, the CFTC also delayed the compliance deadline for certain provisions of the external business conduct rules until January 1, 2013.

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