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Compliance Clinic

Swap Reforms: Tasks For Asset Management CCOs

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Asset managers are gearing up to comply with many Dodd-Frank Act-mandated swap regulations in the coming months. This *Compliance Clinic* examines six near-term tasks chief compliance officers at these firms should undertake, though the task list will grow as regulators continue to adopt final rules, including uncleared swap margin requirements and swap trading execution requirements.

1. Classify trades as swaps, security-based swaps, mixed swaps or as outside the new derivatives regulatory regime

The new Dodd-Frank regulatory regime applies to a wide range of derivatives. Jurisdiction over these instruments is divided between the **Commodity Futures Trading Commission** and the **Securities and Exchange Commission**, with “swaps” subject to CFTC jurisdiction, “security-based swaps” subject to SEC jurisdiction and “mixed-swaps” subject to both agencies’ jurisdiction.

Many commonly traded instruments are excluded from these definitions, either in whole or in part. These include spot transactions in foreign exchange and commodities, certain foreign exchange derivatives, options on single securities and groups or indexes of securities, as well as physically settled forward transactions on commodities and securities.

Although classifying a particular instrument into one of these groups is complicated and does not always follow the common names or economic characteristics of the instruments, doing so properly is important for a wide variety of regulatory purposes—from determining an asset manager’s registration obligations with the CFTC or SEC, to assessing requirements for, and costs of, trading such instruments.

2. Obtain CICIs and ensure any reporting obligations are met for clients that are “reporting counterparties”

The CFTC’s swap reporting regime is already effective. Where an asset manager transacts with a CFTC-registered swap dealer,

the swap dealer is the reporting counterparty and neither the asset manager nor its client is primarily responsible for preparing and submitting swap data reports. But to the extent an asset manager transacts with a non-registered dealer—for example, a non-U.S. entity that operates under the swap dealer *de minimis* threshold—it should determine whether it or its client is the reporting counterparty for reportable swaps.

In addition, whether or not an asset manager or its client is the reporting counterparty, the manager will need to ensure that it and each of its clients (other than individuals) obtains a legal entity identifier, or LEI. The CFTC has designated the **Depository Trust & Clearing Corp.** and **SWIFT** to provide interim LEIs—termed CFTC Interim Compliant Identifiers, or CICIs—until a global system is operational.

Asset managers and their clients must obtain a CICI if they enter into new swaps on or after April 10, 2013. If they have not entered into swaps since that date but have transacted certain swaps that were open on or were entered into since July 21, 2010, they are required to obtain a CICI by Oct. 17, 2013. To obtain a CICI, asset managers can visit the CICI Utility website.

3. Adhere to the “August 2012 ISDA D-F Protocol” or negotiate a bilateral alternative with swap dealers by May 1

The CFTC has adopted external business conduct rules governing the relationship between a swap dealer and any non-swap dealer. These requirements are triggered when a swap dealer enters into a swap with, offers to enter into a swap with or recommends a swap or a swap trading strategy to a non-swap dealer counterparty. They are divided into three broad categories: requirements relating to the verification of counterparty eligibility to enter into swaps; disclosure requirements; and suitability and



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sales practice standards.

To meet many of these requirements, swap dealers will need prospective counterparties to give them representations. In turn, many clients will expect their asset managers to educate them on the requests they are receiving and help them give swap dealers the information needed to avoid disruptions in trading. Depending on particular arrangements with their clients, asset managers may provide the required representations to, and receive information from, swap dealers on behalf of their clients.

The **International Swaps and Derivatives Association** has released a series of protocols to facilitate compliance with new swaps rules. The August 2012 D-F Protocol is designed primarily to address the external business conduct rules. Market participants can adhere to this Protocol in preparation for the rules' May 1, 2013, general compliance date. If market participants choose not to adhere to this Protocol, they will need to enter into bilateral agreements with their swap dealers so the dealers can ensure they are meeting their regulatory requirements.

4. Classify clients as Category 1, 2 and 3 entities to determine clearing deadlines for IRS and CDS that are subject to mandatory clearing

To date, the CFTC has designated several specific classes of interest rate swaps and credit default swaps as subject to mandatory clearing. The compliance date for each clearing determination will be phased in according to the type of market participants that are counterparties:

- *Category 1:* Includes swap dealers, major swap participants (MSPs) and "active funds." An active fund is any private fund, other than a third-party subaccount, that executes 200 or more swaps per month based on a monthly average over the preceding 12 months, beginning Nov. 1, 2012

- *Category 2:* Includes commodity pools, private funds (other than active funds) and persons predominantly engaged in banking or financial activities, as well as asset managers, registered investment companies and pooled investment vehicles other than third-party subaccounts

- *Category 3:* Includes third-party subaccounts, employee benefit plans subject to the Employee Retirement Income Security Act and non-financial end users. A third-party subaccount is a client account managed by an unaffiliated and independent asset manager, where the asset manager is responsible for the documentation necessary for the account's owner to clear swaps

Asset managers should understand these three primary counterparty classifications to determine the appropriate classification of, and therefore the applicable clearing compliance date for, each client (see box).

5. Negotiate clearing arrangements with primary and backup FCMs and choose clearinghouses ahead of clearing deadlines

Asset managers that are not themselves members of a derivatives clearinghouse will need to arrange for one or more clearing members to clear their swaps. Clearing members that clear swaps on behalf of customers must be registered with the CFTC as futures commission merchants. Market participants should consider contracting for clearing services from more than one FCM so that, if the primary FCM fails, positions can be "ported" to another clearing member of the clearinghouse instead of becoming subject to an unwind process.

The swap clearing documentation between an FCM and its customers continues to evolve. At a high level, the swap clearing relationship between a customer and an FCM clearing member is based on the futures clearing model and involves three primary documents:

- A futures and options agreement that describes the relationship between the customer and the FCM clearing member
- An over-the-counter clearing addendum to the futures and options agreement that outlines provisions related to the clearing of swaps
- A cleared derivatives execution agreement, which includes provisions relating to circumstances where swaps are not successfully cleared

Asset managers should start negotiating clearing arrangements now to avoid unnecessary delays or last minute scrambles.

6. Collect information and calculate trading thresholds for MSP registration requirements

Market participants that exceed specified thresholds, measured daily and calculated quarterly, for swaps exposure are required to register with the CFTC as MSPs and will be subject to comprehensive regulation. In short, these thresholds look to

	All designated swaps, other than iTraxx CDS	Designated iTraxx CDS
Swaps between Category 1 entities	March 11, 2013	April 26, 2013
Swaps between Category 2 entities, and between Category 1 and Category 2 entities	June 10, 2013	July 25, 2013
Swaps involving Category 3 entities	Sept. 9, 2013	Oct. 23, 2013

the risk a market participant poses to its counterparties through uncollateralized out-of-the-money positions and the potential risk the market participant may pose to its counterparties determined

by a risk-adjusted swap notional formula. Three safe harbors allow for less frequent and less complex calculations. The CFTC expects only a handful of market participants to exceed the high thresholds in the MSP test.

Asset managers that do not engage in high levels of proprietary swap trading are unlikely to be MSPs, as the test does not attribute a client's swap positions to its asset manager and does not require the aggregation of positions across clients. However, an asset manager's clients, as the direct counterparties to swaps arranged by the asset manager, may qualify as MSPs.

Asset managers that have separate account clients should also consider what information the client will need about its swap positions managed by the asset manager to assess whether it is an MSP. Finally, asset managers will need to know whether their separately managed account clients are MSPs in order to comply with the relevant regulations.

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