

US OTC derivatives reforms
Impact on UK and other non-US asset managers

September 2011

C L I F F O R D
C H A N C E

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Important Notes

Important Notes

References in this guide to “Dodd Frank” are, unless otherwise stated, to the provisions relating to regulation of the derivatives markets in Title VII – the Wall Street Transparency and Accountability Act of 2010.

Statements made in this guide are accurate as of September 19, 2011. Not all regulations referenced in this guide are final. The final rules may differ in important ways. Key areas in which final rules are awaited are marked with ● (the absence of a ● does not signify that a final rule has been released).

In this guide, the capitalised term “Swap” is used to refer to a swap as defined in section 721 of Dodd Frank, as distinct from a Security-based Swap defined in section 761 of Dodd Frank. The uncapitalised term “swap” is used for convenience to refer to Swaps and Security-based Swaps generally.

Based on the CFTC’s current timetable, the rules requiring clearing and exchange-trading of Swaps are not likely to take effect before mid-2012. The SEC has not released an indicative implementation timetable for the equivalent provisions for Security-based Swaps. Other Dodd Frank provisions relating to swaps are likely to be implemented according to a more accelerated timetable.

This guide is intended as general information only and does not constitute legal advice. It is a selective guide and does not cover any aspect of Dodd Frank in detail. Users of this guide should take specific legal advice with respect to their own regulatory status.

This guide assumes that asset managers will, in general, trade on behalf of their clients with counterparties that are financial institutions and that are, where applicable, registered Swap Dealers or Security-based Swap Dealers for Dodd Frank purposes.

A glossary of certain terms not otherwise defined in the core of this guide is set out at the end of this guide.

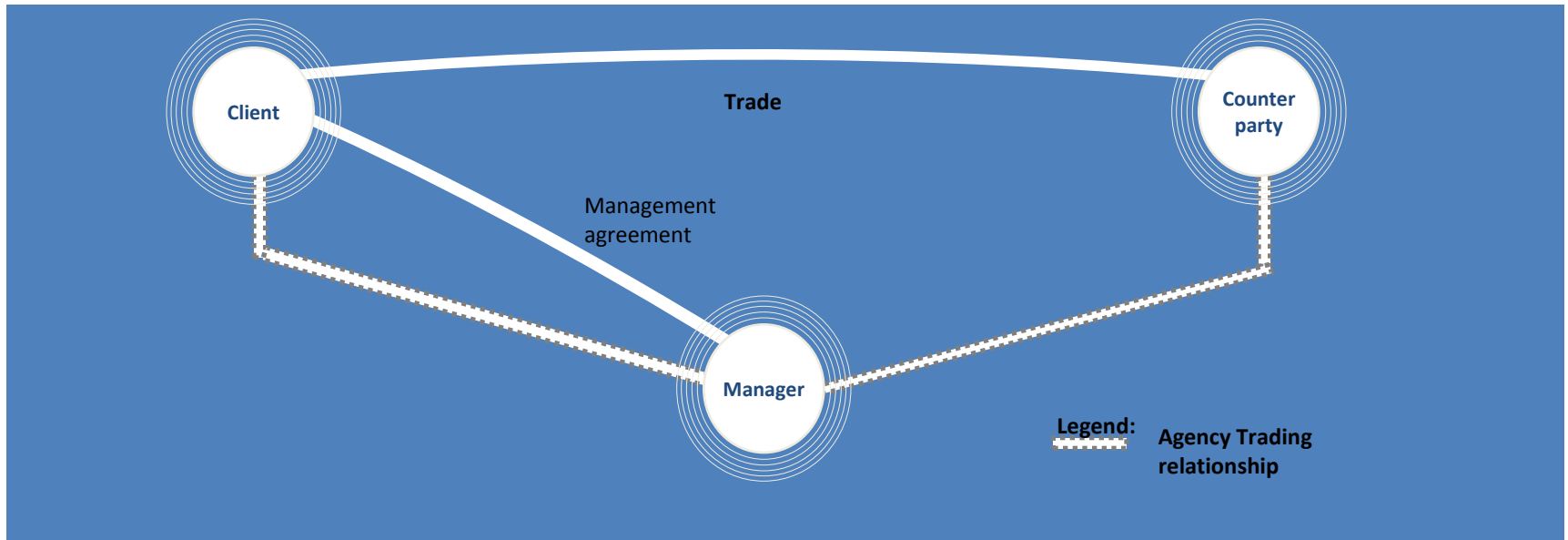


Overview of asset management

Overview of asset management

Asset managers trade OTC derivatives as agent for their clients

Figure 1 – Stylised example of agency structure



– Clients include:

- Pooled vehicles (e.g., regulated funds such as UCITS, private (unregulated) funds, “life funds” (i.e., pooled assets of an insurance company usually in the same group as the manager));
- Segregated mandates (e.g., corporate pension funds, insurance companies, local authority mandates, charities, other institutional schemes and sovereign wealth funds);
- Private client money other than in pooled vehicles

– Asset managers include:

- An independent UK asset manager; or
- An entity within a larger group, including:
 - » A global asset management group;
 - » A financial services group (which may include an insurance or banking business);
 - » A non-financial services group

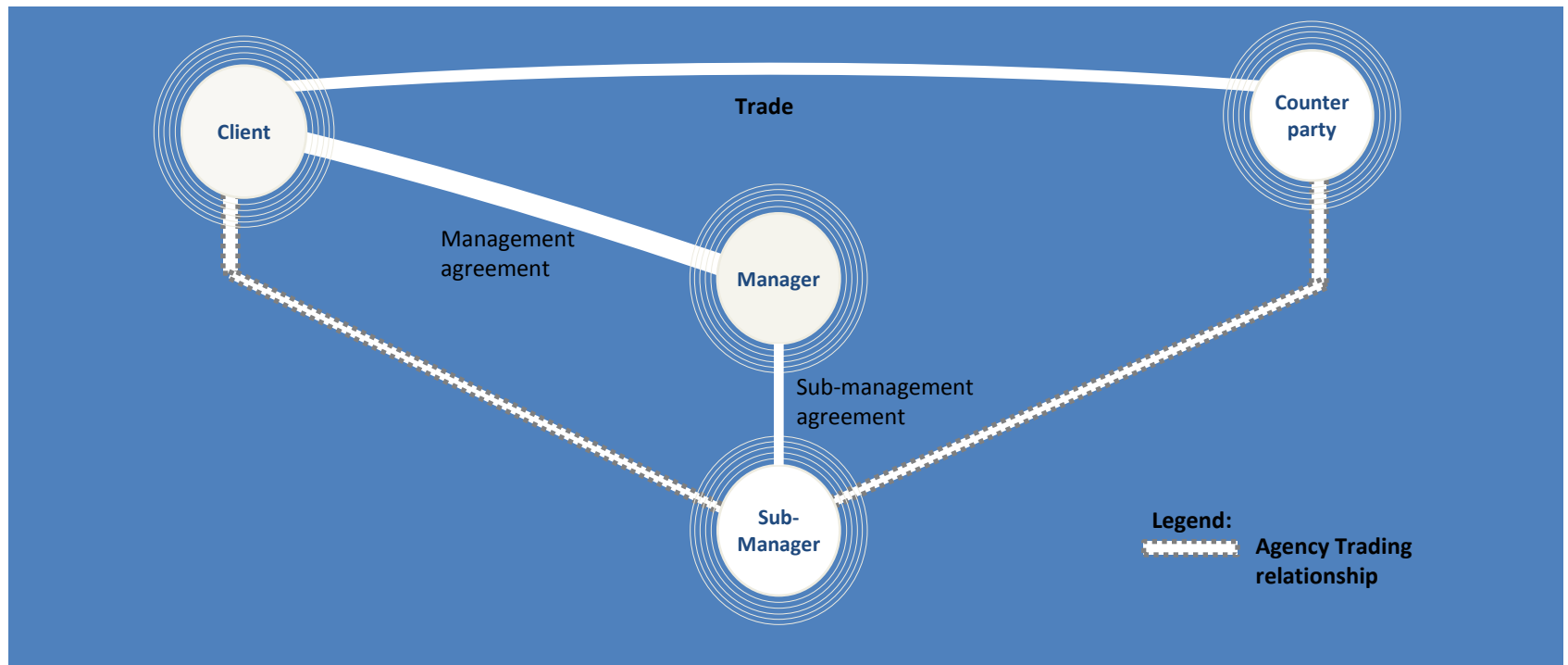
– Counterparties include:

- Investment banks
- Credit institutions
- Broker-dealers

Delegation of management

An asset manager may delegate discretionary management of underlying assets on behalf of a US or non-US client to a US or non-US sub-manager

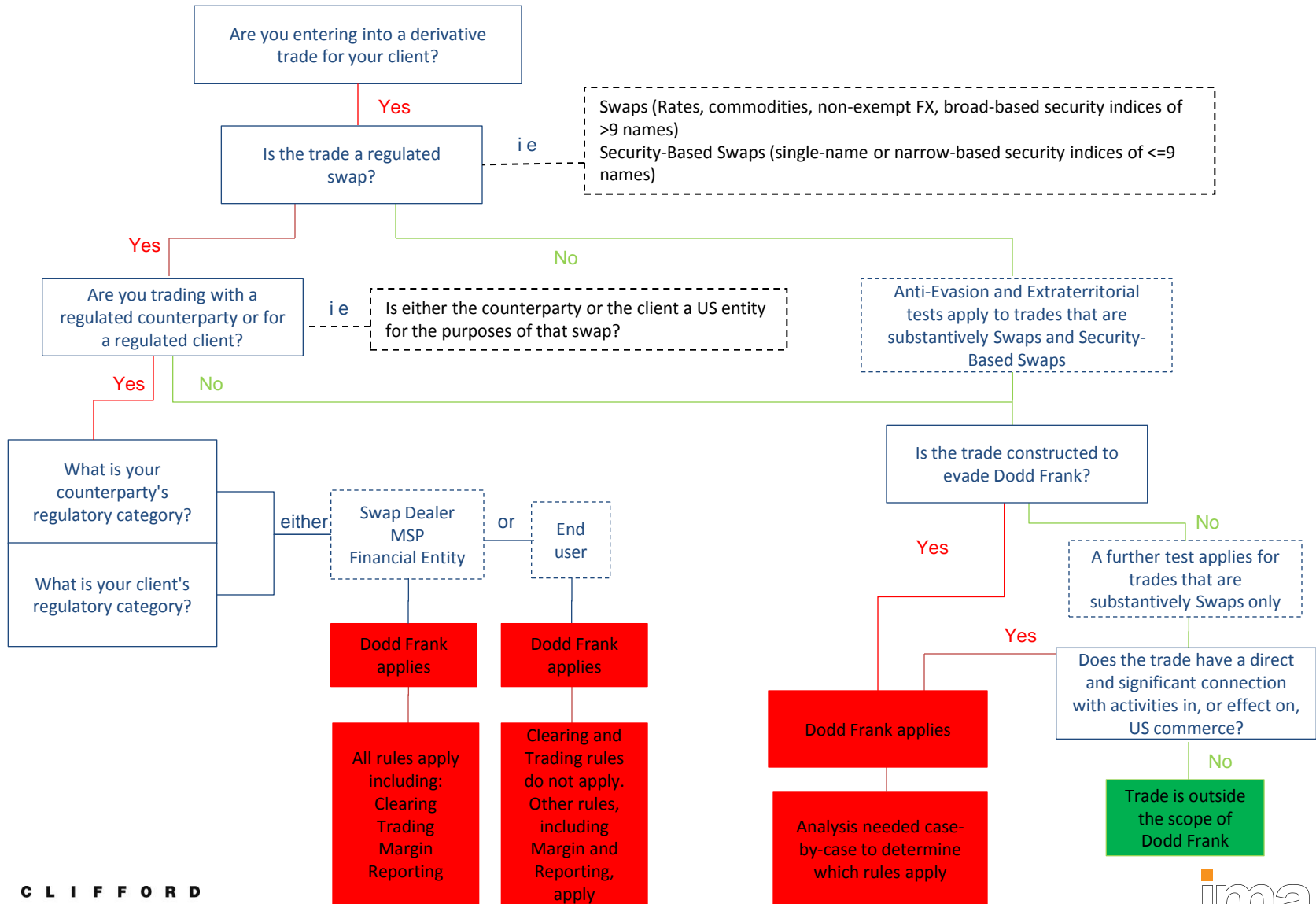
Figure 2 – Stylised example of delegation of management structure





Dodd Frank decision tree

Dodd Frank Application – decision tree for asset managers





What is regulated as a swap?

What is regulated as a swap – statutory definition

Section 721 of Dodd Frank defines a Swap as an agreement, contract or transaction that:

- (i) is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind;
- (ii) provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence; or
- (iii) provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred, including specified types of transaction (summarised on next page)

Section 761 of Dodd Frank defines a Security-based Swap as a swap that is based on:

- (i) an index that is a narrow-based security index, including any interest therein or on the value thereof;
- (ii) a single security or loan, including any interest therein or on the value thereof; or
- (iii) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer.

Swaps are regulated by the CFTC; Security-based Swaps are regulated by the SEC

Note that the definitions of Swap and Security-based Swap do not distinguish between swaps that have some US nexus (for example, US\$ rate or currency swaps or CDS on Ford or Boeing) and those that do not (for example Euro/Sterling rate or currency swaps or CDS on Daimler or EADS)

What is regulated as a swap – certain transaction types

Note – this is not an exhaustive list of applicable transaction types

1. CFTC jurisdiction:	Rates products Commodities (non-physical) Swaps on broad-based security indices with more than 9 names Non-exempt FX trades (including NDFs, deliverable forwards, currency swaps)
2. SEC jurisdiction:	Single-name security-based swaps (e.g., CDS, equity swaps, TRS) Swaps on narrow-based security indices based on 9 or fewer names LMA-style loan participations (i.e. no transfer of beneficial ownership) Options on government and municipal securities
3. Non-regulated:	Hybrid securities – generally regulated as securities, not as swaps FX trades subject to Treasury exemption (i.e. only transactions with an initial exchange of a currency pair reversed by a final exchange of the same currency pair on specified date)



When will
Dodd Frank apply?
What is a US entity?

When will Dodd Frank apply?

- Dodd Frank will apply:
 - If either party (i.e. the client or the counterparty, as principals) to the swap is a US entity regardless of the domicile of the other party
 - The rules for determining whether a party is a “US entity will depend on the swap type and whether that swap type is regulated by the CFTC or the SEC
 - If the swap is arranged to evade Dodd Frank regulations or (in the case of CFTC-regulated Swaps only) has a direct and significant connection with activities in, or effect on, commerce of the US (see page 29)
- Pages 15-17 set out factors for determining whether either party is a “US entity”
- The determination of the applicability of Dodd Frank is based on the status of the principals to the trade (i.e. the client and the counterparty).
 - The status of the manager or sub-manager who arranges the swap should not be relevant, except that Dodd Frank trading and business conduct provisions may apply to a US manager or US sub-manager (see page 18)
- The location of the client’s assets, bank accounts, custodians or other service providers should not be relevant



What is a “US entity”? (1) Financial institutions and non-fund entities



For these purposes, a “financial institution” generally means a bank, a branch of a bank or similar entity that is acting as counterparty to a client “Non-fund entity” means a corporate entity, trust, partnership or other entity that is not a fund or investment vehicle. It includes insurance companies and would apply to many segregated mandates where the client is not a fund or investment vehicle or US municipality

Financial institution or non-fund entity

A financial institution or non-fund entity which is not established or operating from a presence in the United States should not be considered to be a US entity. However, a US branch of a non-US bank is likely to be considered to be a US entity.

US parent or affiliates:

- A counterparty would not be considered to be a “US entity” simply because it has a US parent or US affiliates

Non-US branches of US financial institutions:

- The status of non-US branches of US financial institutions remains subject to final rule making. The extent to which swaps executed by such non-US branches with non-US clients should be subject to Dodd Frank remains under debate. The CFTC and the US banking regulators have taken differing positions which have not yet been reconciled. It remains unclear whether swaps with non-US clients would be subject to Dodd Frank simply because the counterparty is a branch of a US financial institution

US credit support provider:

- A counterparty would not be considered to be a “US entity” simply because its obligations are guaranteed or supported (for example, by a letter of credit) by a US entity, whether affiliated or unaffiliated

US accounts or assets:

- A counterparty would not be considered to be a “US entity” simply because maintains assets or bank accounts, or has custodians, in the United States

Regulation in the US:

- A counterparty may be considered to be a “US entity” if it is carrying on certain US-regulated business
 - For example, the London branch of a European bank that routinely deals in swaps with US counterparties is likely to be required to register as a “Swap Dealer” and would be subject to Dodd Frank in that capacity.
 - It is not clear if the whole swap book of such an entity would be subject to Dodd Frank, or just the swaps executed by that regulated branch with US entities
- Other types of US regulation (for example, status as an SEC reporting company) are not expected to confer “US entity” status for Dodd Frank purposes

Recipient of US Federal bail-out assistance (including TARP funds):

- A counterparty which was a recipient of US Federal bail-out assistance (including TARP funds) should not be considered to be a “US person” in the absence of any other connection with the US

What is a “US entity”? (2) Funds or investment vehicles

For these purposes, a “fund or investment vehicle” generally means a collective or pooled investment scheme, including unregulated funds and regulated funds such as UCITS, US mutual funds, pooled pension funds and commodity pools. This predominantly relates to asset managers’ clients, rather than to counterparties.

Funds and Investment Vehicles

Determining whether a fund or investment vehicle is a US entity is likely to depend on what the swap type it is engaged in, and whether that swap type is regulated by the CFTC or the SEC. Entities which trade both Swaps and Security-based Swaps will be subject to both CFTC and SEC rules.

- **CFTC regulation:** a fund or investment vehicle that engages in Swaps will very likely be a US entity if it is a commodity pool as defined in the Commodity Exchange Act. A fund or investment vehicle will be a commodity pool for those purposes, irrespective of the jurisdiction of its organisation, if more than 10% of its beneficial ownership is held by US persons, the majority of the fund or investment vehicle’s business activities are conducted in the US, or if the fund or investment vehicle’s principal offices are located in the US
- **SEC regulation:** the SEC regulations are currently uncertain, and it is not clear whether the SEC will impose a look-through test to the beneficial owners of the fund or investment vehicle, but it is likely that applicability will depend primarily on the following three issues:

- **Is the fund or investment vehicle incorporated or organised in the United States?**

or

- **Is the fund or investment vehicle resident in the United States – i.e. does it have a physical presence or operations in the United States? (It is unlikely that merely maintaining assets or bank accounts, or having a custodian, in the United States would constitute US residency)**

or

- **Is the fund or investment vehicle a registered Investment Company?**

The same analysis should apply to a master feeder fund with US investors (even if those US investors are investing indirectly through a non-US feeder fund)

Examples:

- A USD/HKD currency swap arranged by a London-based asset manager between a Hong Kong-based dealer and a Luxembourg-incorporated Fund will be subject to CFTC regulation if US investors own more than 10% of the Fund’s units
- A credit default swap referencing General Motors arranged by a London-based asset manager between the same Hong Kong-based dealer and the same Luxembourg-incorporated Fund should not be subject to SEC regulation, regardless how much of the Fund’s units are owned by US investors (unless the swap is arranged to evade Dodd Frank regulations that would otherwise be applicable)

What is a “US entity”? (3) US municipalities and special entities

- US municipalities are US entities for Dodd Frank purposes
- Additional rules apply to US municipalities and other entities that are classified as “special entities” for Dodd Frank purposes

Special entities

A “special entity” is defined as:

- a Federal agency;
- a State, State agency, city, county, municipality, or other political subdivision of a State;
- any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002);
- any governmental plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); or
- any endowment, including an endowment that is an organisation described in section 501(c)(3) of the Internal Revenue Code of 1986

- Swap Dealers and Major Swap Participants executing swaps as counterparty to special entities must comply with additional business conduct rules, including making special disclosures and ensuring that the special entity has an independent advisor acting on its behalf and advising as to the risks involved in the swap transaction
- In practice, Swap Dealers are likely to require counterparties to make a representation as to whether they are or are not special entities

Dodd Frank applicability to sub-managers



- Where a swap is arranged by a “US sub-manager” between a non-US client and a non-US counterparty
 - It should not make the two non-US principals to the swap subject to mandatory clearing and exchange-trading
 - The US sub-manager’s own conduct would be subject to Dodd Frank; for example, the anti-fraud and anti-manipulation provisions
 - The extent of the extra-territorial effect of Dodd Frank in these circumstances remains subject to rulemaking and public consultation
- A “US manager” delegating to a non-US sub-manager does not per se subject the non-US sub-manager or the principals to any swap arranged by the non-US sub-manager to Dodd Frank
- A manager or sub-manager is a “US manager” or a “US sub-manager” if it is incorporated or organised in the United States or acting out of an office in the United States



Regulated entity types

Client Regulatory Status

If a client is a US entity, the Dodd Frank rules that apply will depend on its status under the following four major regulatory categories:

- Swap Dealers
- Major Swap Participants
- Financial Entities
- End Users

Certain additional sub-categories apply in certain circumstances:

- Whether the client is a “special entity” as discussed above at page 17
- In relation to the margin rules for non-cleared swaps, whether the client is a
 - swap entity
 - high-risk financial end-user
 - low-risk financial end-user or
 - non-financial end-user

[See Annex](#)

Regulatory Categories – Swap Dealers

A Swap Dealer is an entity that:

- Holds itself out as a dealer in swaps
- Makes a market in swaps
- Regularly enters into swaps with counterparties in the ordinary course of business for its own account or
- Engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps

The definition of “Security-Based Swap Dealer” follows the definition of “Swap Dealer”

An entity may be a Swap Dealer for one or more types of swap product but not for others

Entities that regularly enter into swaps but are not generally known as dealers or market makers are not expected to be subject to registration as a Swap Dealer

Standard swap documentation is likely to require each counterparty to make a representation about whether it is a Swap Dealer

Swap Dealers are required to register with the CFTC; Security-based Swap Dealers are required to register with the SEC

Standard swap documentation is likely to require a Swap Dealer (or Security-based Swap Dealer) to make a representation that it is validly registered

It is not expected that many asset management clients (or the asset managers of such clients) would qualify as a Swap Dealer

Regulatory Categories – Major Swap Participants

A Major Swap Participant is an entity that is not a Swap Dealer and:

- That maintains a “substantial position” in swaps of any major swap category except positions held for hedging or mitigating commercial risk or
- Whose positions create “substantial counterparty exposure” that could have serious adverse effects on the financial stability of the United States banking system or financial markets or
- That is highly leveraged and not subject to Federal banking capital requirements and maintains a substantial position in swaps of any major swap category

The definition of “Major Security-Based Swap Participant” follows the definition of “Major Swap Participant”

The SEC and CFTC have published draft rules that set quantitative definitions for “substantial position” and “substantial counterparty exposure” – see the Glossary

Standard swap documentation is likely to require each counterparty to make a representation about whether it is a Major Swap Participant

Major Swap Participants are required to register with the CFTC; Security-based Major Swap Participants are required to register with the SEC

Standard swap documentation is likely to require a Major Swap Participant (or Major Security-based Swap Participant) to make a representation that it is validly registered

An entity may be a Major Swap Participant for one or more types of swap product but not for others

The asset manager will either need to determine that each client is not a Major Swap Participant, or to obtain a representation from the relevant client that it is not a Major Swap Participant. The likely number of Major Swap Participants is unknown; the CFTC has expressed a view that there are not likely to be many, but it is unclear whether this is correct

Regulatory Categories – Financial Entities

For the purposes of mandatory clearing and exchange-trading, a Financial Entity is an entity that is any of:

- a Swap Dealer or a Security-Based Swap Dealer
- a Major Swap Participant or a Major Security-Based Swap Participant
- a commodity pool
- a private fund under the Investment Advisers Act
- an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of ERISA
- a person predominantly engaged in activities that are in the business of banking or in activities that are financial in nature

There are some limited exceptions, including for entities that are primarily financing vehicles that use derivatives to hedge commercial interest rate and FX exposures

Non-US defined benefit plans and institutions for occupational retirement provision are not specifically caught by Dodd Frank but will be subject to the tests applicable to other entity types

Regulatory Categories – End Users

An End User is an entity that:

- is not a Financial Entity, and
- is using swaps to hedge or mitigate commercial risk, and
- has notified the CFTC or SEC (as applicable) how it generally meets its financial obligations associated with entering into non-cleared swaps

The End User category creates a limited exemption to the requirement to submit swaps for clearing and to execute swap trades on registered exchanges. Other Dodd Frank provisions continue to apply to swaps with End Users



Key obligations under Dodd Frank

Key obligations under Dodd Frank



Title VII of Dodd Frank imposes a number of obligations on entities entering into OTC derivatives. We have set out a summary of the key obligations below.

Clearing	<p>Generally, all swaps regulated under Dodd Frank that are executed by a US entity must be cleared through a derivatives clearing organisation regulated by the CFTC (with respect to Swaps) or a clearing agency regulated by the SEC (with respect to Security-based Swaps).</p> <p>A swap is not required to be cleared if (a) no derivatives clearing organisation or clearing agency is willing, and has been approved, to clear it or (b) one party to the swap is an End User.</p>
Trading	<p>All swaps that are required to be cleared are also required to be executed on a regulated exchange or a swap execution facility (SEF) unless no exchange or SEF is willing to list the swap.</p> <p>Swaps which are exempt from the clearing requirement will also be exempt from the execution requirement.</p>
Margining	<p>All cleared swaps will be subject to margin rules set out by the relevant derivatives clearing organisation or clearing agency – see Annex</p> <p>For non-cleared swaps, margin requirements for both initial and variation margin will be imposed in accordance with guidelines to be published by the CFTC, SEC and Federal banking regulators (as applicable). The margin requirements established for non-cleared swaps are likely to be set at levels that reflect the perceived higher risk associated with non-cleared swaps. The margin requirements will also differentiate between “high-risk” financial entities and “low-risk” financial entities, and set out rules for the types of margin that can be posted, the use to which margin can be put and the type of custody arrangements that must be used. See Annex</p> <p>Current proposals would require US swap dealers to comply with US margin requirements for all non-cleared swaps, including non-cleared swaps with non-US persons. It is not clear if this requirement will appear in the final rules</p>
Reporting	<p>Detailed terms of any swap (whether cleared or non-cleared) must be reported to a Swap Data Repository or a Security-based Swap Data Repository, or, if there is no repository that will accept such a swap, to the CFTC or SEC, as applicable. Cleared swaps will generally be reported by the relevant derivatives clearing organisation or clearing agency. For non-cleared swaps, if only one party to a swap is a US entity, that entity must make the report. If one party is a US swap dealer, the swap dealer must make the report. If one party is a US major swap participant and the other party is not a US swap dealer, the major swap participant must make the report. Otherwise, the parties shall agree which party will report</p>

There are also other obligations not covered here (e.g. record keeping, position limits, antifraud provisions)

Which provisions of Dodd Frank will apply?

If either party to a swap falls into one of the four regulated categories, the Dodd Frank obligations referred to on the previous page will apply as set out below.

Obligation		Entity Type			
		Swap Dealer	Major Swap Participant	Financial Entity	End User
Clearing and trading	Clearing	Applicable	Applicable	Applicable	Not Applicable
	Trading	Applicable	Applicable	Applicable	Not Applicable
Margining	Cleared Swaps	Applicable	Applicable	Applicable	Applicable (if End User voluntarily executes cleared trades)
	Non-cleared Swaps	Applicable	Applicable	Applicable	Applicable but proposals permit threshold to be set by parties below which no margin required
Reporting	Cleared Swaps	Automatic	Automatic	Automatic	Automatic (if End User voluntarily executes cleared trades)
	Non-cleared Swaps	Swap Dealer must report	MSP must report unless swap is with a Swap Dealer	One Financial Entity must report unless swap is with a Swap Dealer or MSP	Swap Dealer or MSP must report; otherwise, parties must agree which party reports



Extraterritorial scope of Dodd Frank

Extraterritoriality under Dodd Frank – “direct and significant connection”

Dodd Frank extends and expands the existing extraterritorial effect of US futures and securities laws to swaps
Swaps

Dodd Frank amends the Commodity Exchange Act to clarify that:

“The provisions of this Act relating to swaps ... shall not apply to activities outside the United States unless those activities:

- 1) have a direct and significant connection with activities in, or effect on commerce of, the United States; or
- 2) contravene such rules or regulations as the [CFTC] may prescribe or promulgate ... to prevent ... evasion.”

Dodd Frank does not provide guidance on what would be considered to be a “direct and significant connection” with activities in, or effect on commerce of, the United States.

However, the Commodity Exchange Act already contains references in other provisions to activities with a “direct and significant connection” to the United States. This has been interpreted broadly in the past. For example, the CFTC has conducted investigations into allegations of LIBOR fixing where all the relevant activities took place outside the US, on the basis that there was a “direct and significant connection” to US futures and other products.

The Commodity Exchange Act and the Securities Exchange Act contain extensive anti-fraud and anti-manipulation provisions. Breach of these provisions is a criminal offence, so where a client of an asset manager commits a breach the Department of Justice may allege conspiracy on the part of the asset manager. There is also aiding and abetting liability for many offences under these Acts

Compliance procedures and training should be adopted to make traders aware of the US impact of their transactions

Security-based swaps

The Securities Exchange Act is amended to read:

“No provision [of this Act] or any rule or regulation thereunder, shall apply to any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States, unless such person transacts such business in contravention of such rules and regulations as the [SEC] may prescribe ... to prevent ... evasion.”

There is no equivalent provision regarding activities with a “direct and significant connection” with the US in relation to security-based swaps. Activities which take place outside the jurisdiction of the US in relation to security-based swaps will only be caught if they contravene rules prescribed by the SEC.



Anti-fraud and anti-manipulation provisions

Anti-fraud and anti-manipulation provisions

Dodd Frank extended existing anti-fraud and anti-manipulation provisions from the futures and securities regimes to swaps, and created certain new offences. These provisions include:

- Extension of “10b-5” liability to Swaps and Security-based Swaps. This makes it an offence to make an untrue or incomplete statement, or omit a material fact that, in light of the circumstances in which a statement is made, render the statement incorrect or misleading. There is no affirmative obligation to make statements (except where mandatory disclosure is required, for example, with respect to swaps with special entities), but where a statement is made, it must be true and complete. In particular, it is worth noting that, with respect to Swaps, the offence is not limited to the “acquisition” of the Swap, but to any statement “in connection with” the Swap, potentially covering life-cycle events
- Potentially manipulative trade practices, including fictitious or “wash” trades (where no risk is actually assumed), “spoofing” (opening and simultaneously closing positions, giving the impression of greater liquidity than may actually exist) and “reckless disregard for orderly closing” (a new offence directed at trading during the closing minutes of the trading day)

The standard of care for many of these offences is recklessness: manipulation does not need to have been intentional or in fact to have occurred. These offences may affect many current practices used for legitimate business purposes

Compliance training and procedures should be adopted to address and mitigate potentially manipulative activity



Glossary

Glossary

Major Swap Participant definitions (equivalent terms apply to Major Security-based Swap Participants):

- Substantial Position means, in the determination of whether an entity is a Major Swap Participant, EITHER of the following:
 - (a) a daily average current uncollateralised exposure of \$1 billion or more in any applicable major category of swaps, except that the threshold for the rate swap category would be \$3 billion; OR
 - (b) daily average current uncollateralised exposure **plus** potential future exposure of \$2 billion or more in any applicable major swap category, except that the threshold for the rate swap category would be \$6 billion

For purposes of this definition “major category of swaps” means (i) rate swaps (any swap based on reference rates such as interest rates or currency exchange rates), (ii) credit swaps (any swap based on instruments of indebtedness or related indices), (iii) equity swaps (any swap based on equities or equity indices) and (iv) other commodity swaps (any swap not included in the first three categories, including any swap based on physical commodities)

- Substantial Counterparty Exposure means, in the determination of whether an entity is a Major Swap Participant has an aggregate current uncollateralised exposure of \$5 billion, or a sum of current uncollateralised exposure and potential future exposure of \$8 billion, across the entirety of a person’s swap positions
- “Daily average current uncollateralised exposure”, “aggregate current uncollateralised exposure” and “potential future exposure” have specific and detailed definitions in the proposed rules

Glossary

Non-cleared swap margin definitions:

- Swap Entity means a Swap Dealer, a Security-based Swap Dealer, a Major Swap Participant or a Major Security-based Swap Participant

- Financial End-User means an entity that is
 - a Financial Entity (see page 23)
 - A person that would be a commodity pool or a private fund (as described in the definition of Financial Entity) if it were organised under US state or federal law
 - A foreign government or political subdivision, agency or instrumentality; or
 - Other wise so designated by the banking regulators or the CFTC, as applicable

- Non-Financial End-User means an entity that is not a Swap Entity or a Financial End-User

- High-Risk Financial End-User means a Financial End-User that is not a Low-Risk Financial End-User

- Low-Risk Financial End-User means a Financial End-User that can represent that it
 - Does not have substantial swap exposure
 - Predominantly uses swaps to hedge or mitigate business risks
 - Is subject to capital requirements established by a prudential regulator or state insurance regulator

- Minimum Transfer Amount means the minimum amount of margin (or additional margin) a party to a swap would be required to deliver on any day. A change in the margin amount below the Minimum Transfer Amount would not result in additional margin being delivered



Annex

Certain Regulatory Requirements –Cleared Swaps



Infrastructure and margin

- Specific requirements for cleared trades will generally be set by the rules of the applicable clearinghouse
- Clearinghouses must be registered as “derivatives clearing organisations” by the CFTC to clear Swaps or as “clearing agencies” by the SEC to clear Security-based Swaps
- Only certain entities that are “clearing members” or “clearing brokers” of a clearinghouse will have direct access to the clearinghouse
- Entities that executes swaps and that are not clearing brokers will need to appoint a clearing broker regulated by the CFTC as a Futures Commission Merchant or by the SEC as a Broker-Dealer to intermediate their swaps with clearinghouses
- Clearing brokers will require their customers to execute standard brokerage documentation, including customer agreements and specific terms for cleared derivatives, including a give-up agreement
- Customers will be required to post margin to the clearinghouse via their clearing broker in respect of all cleared swaps
- The amount of margin required for any particular swap type will be set by the relevant clearinghouse
- Eligible asset types that may be posted, and custody rules, will be set by the clearinghouse subject to general regulations set by CFTC or SEC
- The exact method for ring-fencing margin will depend on which clearinghouse is used; some methods give greater protection against the bankruptcy of other customers and clearing brokers than others
- Availability of excess cleared derivative margin to secure other positions with a clearing broker or its affiliates will be subject to CFTC or SEC regulations

Documentation

- The structure of the documentation that clearing customers will need to enter into with clearing brokers to clear swaps is expected to be similar to that used for futures and options clearing
- Each clearing customer will be required to execute a “customer agreement” (sometimes known as a “clearing agreement”) with its clearing broker(s). The customer agreement sets out the obligations of the customer with respect to cleared swaps. It generally does not contain a commitment by the clearing broker to clear any swap, and it does not confer many rights on the customer. The customer can generally transfer its swaps and the related margin to another clearing broker freely (as long as the existing broker would not suffer a margin shortfall as a result). The customer can also generally terminate the customer agreement upon a short notice period (subject to satisfying its obligations to the broker)
- The Futures Industry Association is supporting a working group to prepare standard terms for cleared swaps to be incorporated into clearing brokers’ existing forms of customer agreement. Draft documentation has not been finalised. Some clearing brokers may use modified forms of the standard terms.
- Clearing customers may also execute “execution agreements” with executing brokers, who will accept orders from the customer for swaps to be executed on trading facilities (such as exchanges) or bilaterally with other customers of the broker, where the rules permit
- Customers that use executing brokers will also require a “give-up agreement” under which the transaction will be transferred to a clearing broker for clearing.
- The Futures Industry Association and ISDA are supporting a working group to prepare a standard execution agreement with optional “give-up” arrangements. Draft documentation has not been finalised.

Certain Regulatory Requirements – Non-cleared Swaps

Infrastructure and documentation

- Non-cleared swaps will be executed on a bilateral basis
- Existing trading documentation (e.g. ISDAs) will likely be used to document non-cleared swaps with supplements for additional disclosure and collateral terms
- Swap Dealers are likely to require asset managers' clients to acknowledge in trading documentation that risks related to non-cleared swaps have been disclosed to them
- If the asset manager's client is a "special entity" (see page 17), the client are likely to be required to make representations that it has received additional risk disclosure and is represented by an independent advisor with respect to the swap
- Asset managers are likely to be required to represent that they have given the required disclosure to their clients and that their clients have received necessary advice with respect to the terms and risks related to the swap
- ISDA may prepare a protocol of certain standard terms for non-cleared swaps

Margin

- CFTC, SEC and banking regulators will require margin to be posted with respect to all non-cleared swaps
- The CFTC and Federal banking regulators have published draft rules. The SEC has not yet published its equivalent rules
- The rules distinguish between "Swap Entities", "Financial End-Users" and "Non-Financial End-Users" (see Glossary for definitions; for clarity, differences in terminology between the CFTC's rules and the banking regulators' are ignored here)
- The banking regulators' rules further categorise Financial End-Users as "high-risk" or "low-risk" (see Glossary). Note that the requirement for prudential capital regulation will disqualify many entities from being Low-Risk Financial Entities
- Low-risk Financial End-Users will only be required to post initial and variation margin if their exposure exceeds a specified threshold. The current proposals anticipate a threshold equal to the lesser of:
 - An amount in the range of \$15 – 45 million; or
 - 0.1 – 0.3% of the relevant Swap Entity's tier 1 capital (i.e. the capital of the relevant Swap Dealer that is counterparty to the Financial Entity)
- The threshold for High-Risk Financial End-Users will be zero: they will always be required to post margin
- Non-Financial End-Users would be subject to a risk threshold under the banking regulators' rules; the CFTC rules allow greater latitude to the parties to reach a bilateral agreement as to margin posting requirements
- Margin will be divided between initial margin, posted against the general risk of default, and variation margin, posted against the mark-to-market value of the swap
- Initial margin will be required to be posted to a third-party custodian and may not be rehypothecated
- Variation margin will likely be commingled with assets of the counterparty and may be rehypothecated. It is therefore subject to credit risk of counterparty
- The required margin amount will be recalculated and must be posted daily; the "Minimum Transfer Amount" (see Glossary) will be \$100,000
- The rules published by the CFTC and the banking regulators contain detailed, but slightly different, rules for how the required margin levels can be calculated. Swap Dealers' discretion with respect to margin calculations will be limited, but their control of the inputs (e.g. risk and mark-to-market levels) will be an important factor

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