

MEMO# 26491

September 6, 2012

CFTC Adopts Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 58-12
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 47-12
INVESTMENT ADVISER MEMBERS No. 28-12
SEC RULES MEMBERS No. 81-12 RE: CFTC ADOPTS CONFIRMATION, PORTFOLIO RECONCILIATION, PORTFOLIO COMPRESSION, AND SWAP TRADING RELATIONSHIP DOCUMENTATION REQUIREMENTS FOR SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

Recently, the Commodity Futures Trading Commission (“CFTC” or “Commission”) adopted final rules setting forth requirements for documenting the swap trading relationship between swap dealers (“SDs”), major swap participants (“MSPs”), and their counterparties; standards for the confirmation of swaps; and requirements for reconciliation and compression of swap portfolios (“Final Rules”). [\[1\]](#) The Final Rules, which were proposed in three separate notices of proposed rulemaking, [\[2\]](#) and were adopted at § 23.500 through § 23.505, are described briefly below.

Swap Trading Relationship Documentation

The Final Rules include requirements for swap trading relationship documentation. The swap trading relationship documentation must be in writing and is required to include all terms governing the trading relationship between the SD or MSP and its counterparty, including, without limitation, payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation and dispute resolution. The Final Rules specify that the swap trading relationship documentation must include all confirmations of swap transactions (although the timing of confirmations is subject to the Final Rules on swap confirmations, below); credit support arrangements, including initial and variation

margin requirements, if any, the types of assets that may be used as margin and haircuts, if any, investment and rehypothecation terms for assets used as margin for uncleared swaps, if any; and custodial arrangements for margin assets, including whether margin assets are to be segregated with an independent third party.

The swap trading relationship documentation between an SD or MSP and a financial entity, [\[3\]](#) among others, must include written documentation in which the parties agree on the process for determining the value of each swap at any time from execution to the termination, maturity, or expiration of the swap for purposes of complying with the margin requirements under section 4s(e) of the Commodity Exchange Act (“CEA”) and Commission regulations, and the risk management requirements under section 4s(j) of the CEA and Commission regulations. The documentation must include either (i) alternative methods for determining the value of the swap for purposes of complying with the Final Rules in the event of the unavailability or other failure of any input required to value the swap; or (ii) a valuation dispute resolution process.

SDs and MSPs must include a notice in the swap trading relationship documentation regarding the applicability of the orderly liquidation authority under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act to such entities and/or their counterparty. The swap trading relationship documentation also must contain a notice that, upon acceptance of a swap for clearing by a derivatives clearing organization (“DCO”): (i) the original swap is extinguished; (ii) the original swap is replaced by equal and opposite swaps with the DCO; and (iii) all terms of the swap shall conform to the product specifications of the cleared swap established under the DCO’s rules. The Final Rules also require that the SD and MSP obtain a periodic audit of the swap trading relationship documentation that must be sufficient to identify any material weakness in documentation policies and procedures.

The Final Rules regarding swap trading relationship documentation do not apply to swaps that (i) were executed prior to the compliance date of the Final Rules; (ii) are executed on a designated contract market (“DCM”) or executed anonymously on a swap execution facility (“SEF”) that meet conditions specified in the Final Rules; or (iii) are cleared by a DCO.

While the Commission had proposed a compliance schedule related to swap trading relationship documentation, it determined not to finalize that schedule in the form of a rule. Instead, it outlined a series of compliance periods in the Release. SDs and MSPs entering into swap transactions with registered investment companies or third-party subaccounts would, with respect to their trading documentation, be subject, respectively, to either the April 1, 2013 deadline or the July 1, 2013 deadline. [\[4\]](#)

Swap Confirmations

The Final Rules provide time frames for an SD and MSP to provide acknowledgments and confirmations to counterparties. Different types of counterparties are subject to different time frames under the Final Rules. The Final Rules require that an SD or MSP send an acknowledgment to a counterparty that is not an SD or MSP as soon as technologically practicable, but in any event by the end of the first business day following the day of execution. [\[5\]](#) The SD or MSP is required to 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 a financial entity as soon as technologically practicable, but in any event by the end of the first business day following

the day of execution. [6] The procedures must also provide that, upon request by a prospective counterparty, the SD or MSP must provide the prospective counterparty a draft acknowledgment prior to execution that specifies all the terms of the swap transaction other than the applicable pricing terms and other terms that are to be expressly agreed at execution.

A swap transaction executed on a SEF or DCM is deemed to satisfy the confirmation requirements of the Final Rules, as long as the rules of the SEF or DCM establish that the confirmation of all terms of the transaction take place at the same time as execution. A similar rule applies for DCOs. If an SD or MSP nonetheless receives notice that a swap transaction has not been confirmed by a SEF or a DCM, or accepted for clearing by a DCO, the SD or MSP must execute a confirmation for the swap transaction according to the time frames under the Final Rules.

The swap confirmation requirements will be phased in according to a staggered implementation schedule that is based on the type of counterparty and the type of swap. Following are the aspects of the schedule relevant for registered investment companies.

Credit Swaps and Interest Rate Swaps:

- An SD or MSP entering into a swap transaction that is or involves a credit swap or interest rate swap with a counterparty that is not an SD or MSP must send an acknowledgment of the swap transaction, and must, for counterparties that are financial entities, establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes a confirmation for such a swap transaction, as soon as technologically practicable, but in any event by (i) the end of the second business day following the day of execution for the period from the effective date of the Final Rules [7] to February 28, 2014; and (ii) the end of the first business day following the day of execution from and after March 1, 2014.

Equity Swaps, Foreign Exchange Swaps, or Other Commodity Swaps:

- An SD or MSP entering into a swap transaction that is or involves an equity swap, foreign exchange swap, or other commodity swap must provide an acknowledgment, and must establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes a confirmation for each such swap transaction that it enters into with a counterparty that is a financial entity, as soon as technologically practicable, but in any event by (i) the end of the third business day following the day of execution for the period from the effective date of the Final Rules to August 31, 2013; and (ii) the end of the second business day following the day of execution from September 1, 2013 to August 31, 2014; and (iii) the end of the first business day following the day of execution from and after September 1, 2014.

Portfolio Reconciliation and Compression

The Final Rules contain different requirements for portfolio reconciliation and compression, depending on the type of counterparty with which an SD or MSP is engaging in swaps. The portfolio reconciliation and compression requirements of the Final Rules do not apply to swaps that are cleared by a DCO. Each SD and MSP, for example, must establish, maintain, and follow written policies and procedures reasonably designed to ensure that it engages in portfolio reconciliation no less frequently than specified in the following schedule for all swaps in which its counterparty is neither an SD nor an MSP:

- Once each calendar quarter for each swap portfolio [8] that includes more than 100 swaps at any time during the calendar quarter; and
- Once annually for each swap portfolio that includes no more than 100 swaps at any time during the calendar year.

The Final Rules also require that the SD or MSP establish, maintain, and follow procedures to resolve discrepancies in the material terms or valuation of swaps identified as part of a portfolio reconciliation, and report to the Commission and any applicable prudential regulator (and the Securities and Exchange Commission (“SEC”), for security-based swaps) swap valuation disputes in excess of \$20,000,000 (or its equivalent in another currency) if not resolved within five business days for disputes with a counterparty that is not an SD or MSP.

The Final Rules require that SDs and MSPs provide that an SD or MSP must establish, maintain, and follow written policies and procedures relating to portfolio compression including written policies and procedures for periodically terminating fully offsetting swaps and engaging in portfolio compression exercises if requested to do so by a party that is not an SD or MSP.

SDs and MSPs that are currently regulated by a U.S. prudential regulator or are SEC registrants must comply with the Final Rules relating to portfolio reconciliation and portfolio compression within 90 days after the Final Rules are published in the Federal Register. SDs and MSPs that are not currently regulated by a U.S. prudential regulator and are not SEC registrants must comply with the Final Rules relating to portfolio reconciliation and portfolio compression within 180 days after the Final Rules are published in the Federal Register.

Sarah A. Bessin
Senior Counsel

endnotes

[1] Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, Commodity Futures Trading Commission, RIN 3038-AC96 (“Release”), available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister082712.pdf>.

[2] See Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 Fed.Reg. 81519 (Dec. 28, 2010); Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 Fed.Reg. 6715 (Feb. 8, 2011); and Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants, 76 Fed.Reg. 6708 (Feb. 8, 2011).

[3] A registered investment company would be considered a “financial entity” for purposes of the Final Rules. See § 25.500(e).

[4] The Commission adopted a definition of “third-party subaccount” that is substantially the same as the definition it adopted for purposes of the swap clearing implementation schedule: “an account that is managed by an investment manager that (1) is independent of and unaffiliated with the account’s beneficial owner or sponsor, and (2) is responsible for

the documentation necessary for the account's beneficial owner to document swaps as required under section 4s(i) of the CEA."

[5] An "acknowledgment" is defined as "a written or electronic record of all of the terms of a swap signed and sent by one counterparty to the other. For purposes of the Final Rules, the "day of execution" means "the calendar day of the party to the swap transaction that ends latest, provided that if a swap transaction is (A) entered into after 4:00 pm in the place of a party, or (B) entered into on a day that is not a business day in the place of a party, then such swap transaction shall be deemed to have been entered into by that party on the immediately succeeding business day of that party . . ."

[6] A "confirmation" is defined as "the consummation (electronically or otherwise) of legally binding documentation (electronic or otherwise) that memorializes the agreement of the counterparties to all of the terms of a swap transaction. A confirmation must be in writing (whether electronic or otherwise) and must legally supersede any previous agreement (electronically or otherwise). A confirmation is created when an acknowledgment is manually, electronically, or by some other legally equivalent means, signed by the receiving counterparty."

[7] The Final Rules will become effective 60 days after publication in the Federal Register.

[8] "Swap portfolio" is defined as all swaps currently in effect between a particular SD or MSP and a particular counterparty.