REPORT

Futures & Derivatives Law

The Journal on the Law of Investment & Risk Management Products

July 2015 ▪ Volume 35 ▪ Issue 6

HOW DODD-FRANK HAS CHANGED THE DOCUMENTATION NEEDED FOR ENTERING INTO OTC DERIVATIVES

By Sherri Venokur
SVENOKUR LLC

Dodd-Frank has changed many of the rules governing the documentation of OTC Derivatives. This comment will describe some of the issues to be considered when negotiating an ISDA Master Agreement or entering into a new swap transaction under an existing ISDA Master Agreement.

1. The ISDA Master Agreement Schedule

A. Eligible Contract Participant*("ECP")*. Under Dodd-Frank, unless both parties qualify as ECPs (as defined in the Commodity Exchange Act), it is illegal to enter into a swap except on a designated contract market. While the ECP requirement pre-dates Dodd-Frank, the law expanded the definition of swap to include swap guarantees. This means that a swap guarantor also must qualify as an ECP. This question comes up whenever a bank enters into an interest rate swap with its borrower and the loan is guaranteed. The bank must ensure that the guarantee does not cover the loan as well as the swap unless the guarantor qualifies as an ECP. Whenever there is a swap guarantor, the counterparty should represent in the Schedule that each such guarantor, as well as the counterparty itself, qualifies as an ECP or, alternatively, Part 3(b) of the Schedule should include, as a counterparty delivery requirement, ECP verification forms completed and signed by the counterparty and each swap guarantor. It is also suggested that the guaranty itself include a provision that the guaranty covers the swap only if the guarantor qualifies as an ECP.

B. Mandatory Clearing. Pursuant to its authority under Dodd-Frank, the CFTC has designated certain types of swaps, including generic interest rate swaps, for mandatory clearing. If, however, one of the counterparties meets the applicable requirements, there is an exemption for certain end-users that enter into swaps to hedge their commercial risk, including interest rate risk under a floating rate loan. A bank entering into an interest rate hedging swap with its borrower (or another type of swap that has been made subject to mandatory clearing) must have proof that its counterparty qualifies for the end-user clearing exemption because, if the counterparty does not qualify, then the swap must be submitted for clearing. Either in the

THOMSON REUTERS

ISDA Master Agreement Schedule, or in a separate verification form, the counterparty must represent that it meets the requirements for the clearing exemption. These requirements include: (i) that the counterparty is not a "financial entity" (which term includes swap dealers, major swap participants, funds, ERISA plans and persons predominantly engaged in banking activities); (ii) that the transaction is entered into for the purpose of hedging or mitigating commercial risk; and (iii) that the counterparty has complied with the applicable reporting and filing requirements.

Dodd-Frank also requires swap dealers to inform their end-user counterparties of their right to submit a swap for clearing, even if the counterparty qualifies for the end-user exemption from mandatory clearing. If the counterparty has advised the swap dealer that it does not wish to avail itself of this right, the Schedule should include a provision acknowledging this.

C. Special Entity Status. Dodd-Frank supplements the external business conduct rules applicable to a swap dealer that enters into a transaction with a pension plan, government entity or endowment (a ***"Special Entity"***). A swap dealer that enters into a swap with an end-user therefore needs its counterparty to represent whether or not it qualifies as a Special Entity.

D. When Section 3 Representations are Deemed to be Made. The representations found in Section 3 of the ISDA Master Agreement are deemed to be repeated each time the parties enter into a transaction. For purposes of certain Dodd-Frank requirements, a swap includes not only the original transaction, but also any material amendment, mutual unwind or novation of the transaction (a ***"Swap Transaction Event"***). This means, for example, that a counterparty must qualify as an ECP if there is a material amendment to the original swap. For this reason, the parties may choose to specify in Part 4 of the Schedule that any Additional Representations be deemed to be repeated each time there is a Swap Transaction Event.

E. Legal Entity Identifier*("LEI").* In order for a bank to meet its reporting obligations, it must ensure that its end-user counterparty (including any swap guarantor) has obtained an LEI. The bank may wish to provide that, if the end-user does not obtain an LEI, the bank may obtain it on the end-user's behalf, but the end-user still must bear the responsibility for certifying, and recertifying annually, the accuracy of the information provided. Because a swap guarantor is not a party to the Master Agreement, the end-user counterparty must be made responsible for delivering to the bank any swap guarantor's LEI and for ensuring that the guarantor meets its certification and recertification requirements. The LEI requirements may be added either as a document to be delivered under Part 3(b) of the Schedule or as a separate provision in Part 5 of the Schedule.

F. Disclosure and Counterparty Identification Forms. Many banks that provide interest rate hedging swaps to their borrowers are not swap dealers and, therefore, are not bound by the Dodd-Frank business conduct rules. Nonetheless, many such banks provide disclosure documents to their borrowers explain-

ing the risks of entering into a swap transaction. Part 3(b) of the Schedule should include the requirement that the end-user counterparty deliver to the bank a signed disclosure document so that the bank has proof that the document was actually received.

G. Swap Data Reporting and Recordkeeping. Dodd-Frank requires the bank to disclose certain counterparty and transaction information (***"Dodd-Frank Information"***) to regulators and swap data repositories as well as to the bank's affiliates and service providers in connection with meeting such disclosure requirements. A swap data repository may also disclose certain anonymous trade data to the public. It is important that the counterparty consent to such disclosures because they may run counter to the counterparty's understanding of what information will be kept confidential by the bank. The counterparty also should represent to the bank (and such representation should be deemed to be repeated at the time of each Swap Transaction Event) that all Dodd-Frank Information (except for financial information) is accurate and complete in every material respect.

While certain of the above requirements may be covered by the various ISDA Dodd-Frank Protocols, it is unlikely that an end-user entering into an interest rating hedging swap in connection with a loan would sign up for the Protocols, so the bank must obtain the required counterparty representations, consents and information in the Schedule or other document.

2. The ISDA New York Law Credit Support Annex (the "CSA").

Dodd-Frank required the CFTC to propose margin requirements for uncleared swaps, *i.e.*, swaps that are not required to be submitted for clearing. The proposed rules will create a totally new market standard governing the exchange of collateral between those counterparties covered by the rules and, if adopted, will result in the need to amend a substantial percentage of outstanding CSAs and to enter into new CSAs due to certain types of swaps not being subject to the margin rules.

A. Initial Margin. The initial margin rules for uncleared swaps (the ***"IM Rules"***) apply solely to swaps between swap dealers or between swap dealers and certain financial end-users if the swap exposure between the parties (including their affiliates) exceeds $65 million (the **"IM Threshold"**). The particular financial end-users covered by the IM Rules (***"FEU+"***) are those with an average daily aggregate swap notional amount of at least $3 billion for all uncleared swaps and security-based swaps, foreign exchange forwards and foreign exchange swaps, including swaps with affiliates and swaps between affiliates and any counterparty.

Both Parties Must Post Initial Margin. Under current market practice, usually only end-users post initial margin, which is generally a set amount or a percentage of the swap's notional amount and is paid at the commencement of the trade. Under the proposed IM Rules, both parties (except if one party is not an FEU+) must post initial margin, and the amounts are not netted.

Daily Calculation and Exchange. Under the IM Rules, the amount of IM may be calculated either as a set percentage of the trade's notional amount based on trade type and tenor, or by using a pre-approved model based on potential future exposure and capturing all material risks. If the latter, the initial margin amount must be recalculated and paid daily.

Segregation of Initial Margin. Paragraph 6(c) of the CSA permits the secured party holding the Independent Amount to commingle it with, and to treat it the same as, its own assets (including selling and repledging the collateral) unless the parties specify in Paragraph 13(g)(ii) that the provisions of Paragraph 6(c) will not apply. While over the years many end-users have sought to limit the secured party's right to use the initial margin posted by the end-user, dealers have been extremely reluctant to relinquish this revenue source. Because the initial margin amount generally was not tied to exposure, the pledgor faced the counterparty credit risk that the secured party would become insolvent and, ultimately, be unable to return the pledgor's initial margin. Dodd-Frank gave the pledgor the right to have its initial margin segregated with an independent custodian, but the pledgor is permitted to waive this right (and, if it does, probably will receive more favorable pricing than it otherwise would receive from the swap dealer for the trade). Under the proposed IM Rules, initial margin must be segregated with an independent custodian. As a consequence of this, the vast majority of CSAs that require the end-user to post an Independent Amount will have to be amended. In addition, the parties will need to set up and document the appropriate custodial arrangements in order to meet this new requirement.

B. Variation Margin. The proposed variation margin rules for uncleared swaps (the ***"VM Rules"***) apply solely to swaps between swap dealers or between swap dealers and financial end-users. However, they change a number of market standard practices and, if adopted, will require most CSAs to be amended.

Daily Calculation and Exchange. The current practice as documented in the CSA is for variation margin to be calculated and exchanged daily, except if a default or other specified event occurs with respect to one of the parties as set forth in Paragraph 4(a) of the CSA. If a Paragraph 4(a) event does occur with respect to one party, then the other party is relieved of its obligation to transfer or return collateral while such event continues. In addition, while most CSAs provide for the daily calculation and exchange of variation margin, in practice many dealers do not transfer or return collateral unless a demand is made by the end-user. The VM Rules, if adopted, will provide for the daily calculation and exchange of variation margin regardless of whether there occurs an event specified in Paragraph 4(a) of the CSA.

Cash Only. The VM Rules also restrict the type of collateral that may be posted to meet variation margin requirements. Most CSAs include as Eligible Collateral in Paragraph 13(b)(ii) of the Schedule both cash (meaning United States Dollars) and United States treasury obligations, but the VM Rules provide that only cash may be transferred.

No Unsecured Threshold Amount. Finally, while many CSAs provide that variation margin will not be required until the transaction exposure exceeds a certain threshold amount, the VM Rules require that all exposure be collateralized.

No Netting Between Initial Margin and Variation Margin. The CSA provides for a net collateral amount to be transferred from one party to the other based on the difference between the amounts of initial and/or variation margin each party is required to deliver to the other. Under the proposed IM Rules and VM Rules, the initial margin owed by one party cannot be netted against the variation margin owed by the other party. CSAs will need to be amended to reflect this new requirement.

Finally, while the existing margin rules will continue to apply to swaps entered into before the rules become effective, parties will not be able to net their pre- and post-compliance date swaps unless they subject their pre-compliance date swaps to the new margin rules.