

July 30, 2013

## Actions Required Under Derivatives Reforms

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

### Contacts

Barnabas W.B. Reynolds  
London  
+44.20.7655.5528  
[barney.reynolds@shearman.com](mailto:barney.reynolds@shearman.com)

Thomas Donegan  
London  
+44.20.7655.5566  
[thomas.donegan@shearman.com](mailto:thomas.donegan@shearman.com)

Geoffrey B. Goldman  
New York  
+1.212.848.4867  
[geoffrey.goldman@shearman.com](mailto:geoffrey.goldman@shearman.com)

Ian Harvey-Samuel  
London  
+44.20.7655.5000  
[ian.harvey-samuel@shearman.com](mailto:ian.harvey-samuel@shearman.com)

Donna M. Parisi  
New York  
+1.212.848.7367  
[dparisi@shearman.com](mailto:dparisi@shearman.com)

Azam H. Aziz  
New York  
+1.212.848.8154  
[aaziz@shearman.com](mailto:aaziz@shearman.com)

Donald N. Lamson  
Washington, DC  
+1.202.508.8130  
[donald.lamson@shearman.com](mailto:donald.lamson@shearman.com)

James Duncan  
London  
+44.20.7655.5757  
[james.duncan@shearman.com](mailto:james.duncan@shearman.com)

**The first wave of financial regulatory change affecting banks, brokers and their users is in the field of derivatives. Various deadlines for new reporting, clearing and conduct of business requirements are imminent. The manner in which financial institutions deal with their clients and take collateral will undergo significant structural change. Hedge funds and corporates will need new operational processes and documentation in the short term and may also want to reconsider corporate structuring. This note discusses what companies and hedge funds, which use derivatives in their businesses, should be doing to ensure compliance.<sup>1</sup>**

### Mandatory Reporting

In Europe, EMIR<sup>2</sup> requires counterparties to report all derivative contracts (OTC and exchange traded) to a trade repository. Counterparties are also required to maintain a record of their derivative contracts until at least five years after a contract has terminated. The reporting start date under EMIR is dependent on registration of a trade repository for each particular asset class. The European Securities and Markets Authority (“ESMA”) has recently signified that mandatory reporting will start around 1 January 2014 for credit derivatives and interest rate derivatives. The reporting start date for all other asset classes, including equities, FX and commodities is currently also scheduled for 1 January 2014 but this is dependent on a trade repository being registered by 1 October 2013 for the relevant

<sup>1</sup> If you wish to view further information on regulatory reforms, please refer to our dedicated website <http://www.shearman.com/dodd-frank/> and our client publications, which are available [here](#).

<sup>2</sup> Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories.

Contacts (cont.)

Patrick Clancy  
London  
+44.20.7655.5878  
[patrick.clancy@shearman.com](mailto:patrick.clancy@shearman.com)

Winfried M. Carli  
Frankfurt  
+ 49.69.9711.1220  
[wcarli@shearman.com](mailto:wcarli@shearman.com)

John Adams  
London  
+44.20.7655.5740  
[john.adams@shearman.com](mailto:john.adams@shearman.com)

Azad Ali  
London  
+44.20.7655.5659  
[azad.ali@shearman.com](mailto:azad.ali@shearman.com)

David L. Portilla  
New York  
+1.212.848.4468  
[david.portilla@shearman.com](mailto:david.portilla@shearman.com)

Jared R. Gianatasio  
New York  
+1.212.848.4384  
[jared.gianatasio@shearman.com](mailto:jared.gianatasio@shearman.com)

asset class.

In the US, the Dodd Frank Act (“Dodd-Frank”) imposes real time price and regulatory reporting and recordkeeping obligations on market participants. Hedge funds and corporates, however, will rarely be required to act as the reporting party. When an end user’s counterparty is a Swap Dealer or Major Swap Participant (“MSP”), almost all of the reporting burden for execution data is shifted to the end user’s counterparty. However, when a swap is cleared and exchange traded, most of the reporting requirements will be dealt with by the derivatives clearing organisation and/or swap execution facility itself. Similar to in Europe, end users must retain records (in either paper or electronic form) of every swap until five years after the swap has terminated.

There are some substantive differences between EU and US reporting requirements. For example, regulations made under EMIR require information on the collateral for derivatives transactions to be reported, but this is not required in the United States. Various industry solutions nonetheless appear to be emerging. For example, DTCC will be offering reporting for both EU and US purposes through similar technology interfaces which report to its US and EU based repositories. In addition, the exchange and clearing groups ICE and CME are both establishing repositories in the US and EU which will report trades executed on their exchanges or cleared through their clearing houses.

It is vital that buy-side participants and corporates ensure that they are members of the relevant repositories. Appropriate legal entity identifier (LEI) codes will be needed for all companies and funds in a group which are party to derivatives trades.

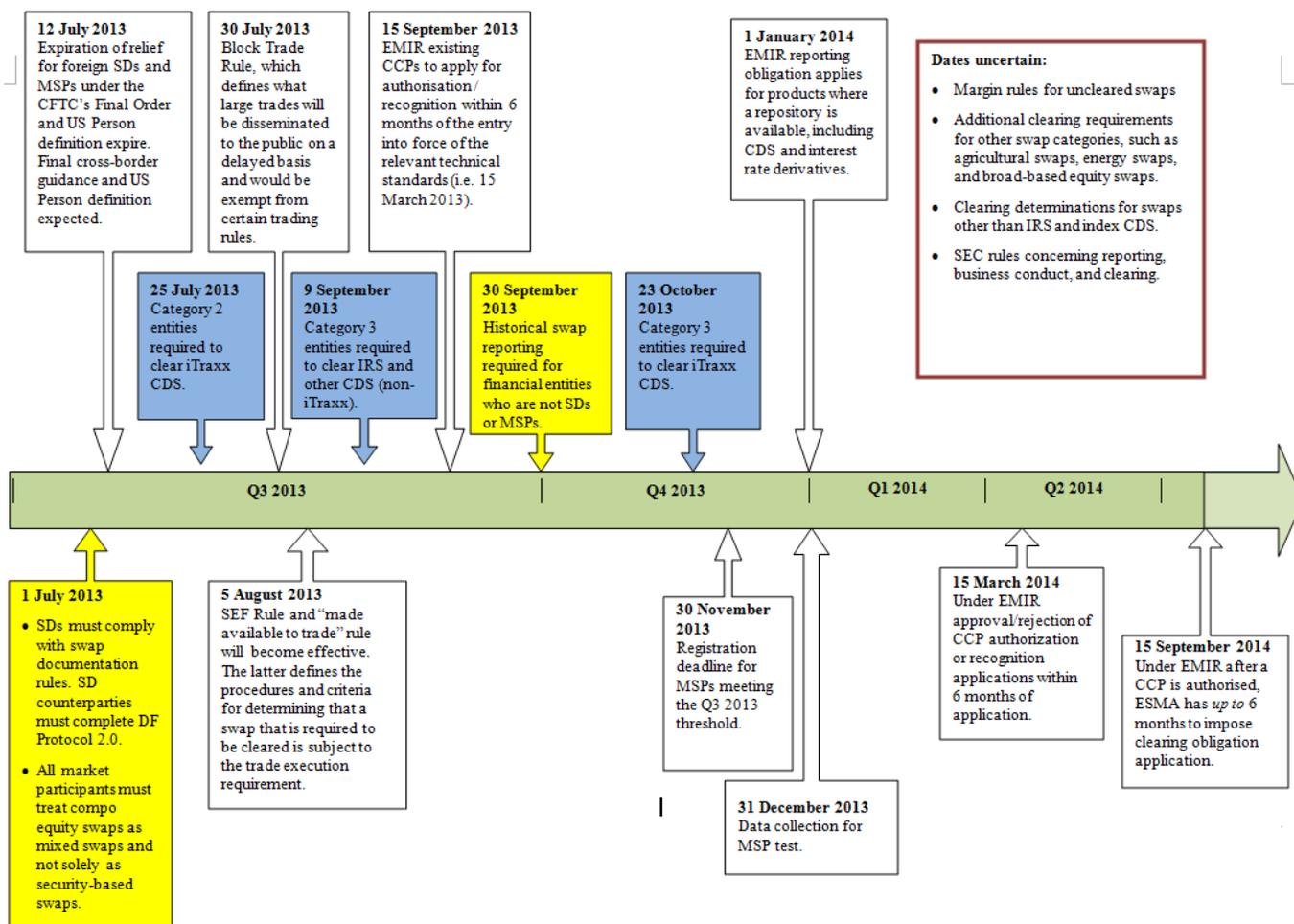


Figure 1: US and EU Regulatory Reporting Timeline. Dates are still uncertain for the Securities and Exchange Commission (“SEC”) rules concerning reporting, business conduct and clearing.

## Conduct of Business Standards for Derivatives

In Europe, EMIR requires that counterparties entering into OTC derivative contracts have appropriate procedures and arrangements in place to measure, monitor and mitigate operational risk and counterparty credit risk, including at least: (i) timely confirmation, where available electronically, of the terms of the OTC derivative contract; and (ii) formalised processes to reconcile portfolios, manage associated risk and identify and resolve disputes between parties. Counterparties must also mark-to-market on a daily basis the value of outstanding contracts. Additionally, financial counterparties must have procedures requiring the segregated exchange of collateral for OTC derivative contracts entered into on or after 16 August 2012.

For non-financial counterparties (“NFCs”), some of these requirements only arise for OTC derivative contracts entered into on or after the clearing threshold is exceeded. An International Swaps and Derivatives Association (“ISDA”) non-financial counterparty protocol has been published this year (the “NFC protocol”) which is aimed at reducing risks to financial counterparties of transacting on the basis of an incorrect classification of their counterparties. NFCs should familiarise themselves with the NFC protocol and should review their own written procedures for notifying ESMA and their competent authority if they exceed the clearing threshold.

## Confirmation Deadlines under EMIR

	CONCLUSION OF OTC DERIVATIVE CONTRACT	FINANCIAL COUNTERPARTIES AND NFCS EXCEEDING THE CLEARING THRESHOLD	NFCS (NOT EXCEEDING THE CLEARING THRESHOLD)
Credit default swaps and interest rate swaps	Up to and including 28 February 2014	T+2	-
	After 28 February 2014	T+1	-
	Up to and including 31 August 2013	-	T+5
	Up to and including 31 August 2014	-	T+3
	After 31 August 2014	-	T+2
Equity swaps, foreign exchange swaps, commodity swaps and all other derivatives	Up to and including 31 August 2013	T+3	T+7
	After 31 August 2013 up to and including 31 August 2014	T+2	T+4
	After 31 August 2014	T+1	T+2

**Figure 2: Timely Confirmation of OTC Derivative Contracts concluded between Counterparties, where T is the date of execution of the contract and the number represents the number of business days following T.**

In the US, Swap Dealers and MSPs are subject to deadlines with respect to confirming swap transactions that differ depending on the type of counterparty the Swap Dealer or MSP is facing on the trade. With respect to swaps entered into by a Swap Dealer or MSP with a non-Swap Dealer or non-MSP counterparty, the Swap Dealer or 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. 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 non-Swap Dealer or non-MSP counterparties, the timeframes are gradually imposed with the most restrictive deadlines not coming into effect until March 2014 or September 2014, depending on the product.

Buy-side participants and corporates will need to ensure that operationally they are able to support more rapid confirmation of any non-documented trades (e.g. transactions concluded by telephone).

### Mandatory Clearing

The US Commodity Futures Trading Commission (“CFTC”) has made a final clearing determination for the first wave of products that will initially be subject to the mandatory clearing requirement. These will be “plain vanilla” fixed-for-floating interest rate swaps, forward rate agreements and basis swaps denominated or settled in US dollars, Euro, pounds sterling or Yen; and CDX and iTraxx index credit default swaps. There may be conditional exceptions from the mandatory clearing requirement available to certain end-users, including where the swap is being entered into to hedge or mitigate commercial risk or is being entered into by a central treasury entity to hedge the risk of an operating affiliate. In Europe, the products to be subject to mandatory clearing have yet to be defined, and will not be announced until central counterparties (“CCPs”) have been re-authorized under the new legislation. The deadline for CCPs to (re-)apply for authorisation is 15 September 2013. Up to six more months may be taken by the competent authorities to

consider applications; and up to six more months may be taken before a clearing obligation is imposed. As a result, we do not expect mandatory clearing in Europe until at least the late Summer of 2014.

In Europe, it is expected that products ultimately subject to mandatory clearing will include those already listed in the US, as well as perhaps some additional commodity and FX derivatives.<sup>3</sup> Once mandatory clearing is required, clearing for these products will be phased in over a period of 3-9 months, starting with trades among dealers and active funds. The products on the CFTC list are all already cleared by existing CCPs.

End-users that transact in the products mentioned will need to determine if they are NFCs and, if so, whether their derivatives are eligible for applicable exemptions for hedging transactions. For example, if a transaction is classed as intragroup under EMIR, the OTC derivative contracts will not be subject to the clearing obligation. If a clearing obligation does apply, NFCs must decide how to use brokers which are members of relevant CCPs. End-users taking advantage of end-user exemptions will nonetheless still have reporting obligations and, in the case of public companies and their subsidiaries, board approval requirements.

### Collateral Issues

There is as yet no international harmonisation on the precise requirements or capital consequences of using collateral for either cleared or non-cleared trades, either at financial institution (clearing member) or CCP level. This may give rise to significant differences in costs to business between jurisdictions.

End-users and buy-side participants should consider how differing collateral requirements impact on where trades should most efficiently be carried. There will likely be significant additional collateral required to support trades in the future and an increased burden in funding and sourcing collateral in the future.

### Documentation

New standardised OTC derivatives documentation has been developed to facilitate more widespread clearing of OTC derivatives. In the US, the Futures Industry Association (“FIA”) and ISDA have published the FIA/ISDA Addendum, which can be “bolted on” to existing futures agreements used by futures commissions merchants (or “FCMs”). The FIA/ISDA Addendum modifies existing terms so as to enable non-standardised futures agreements to be used to clear OTC derivatives across various classes of products and clearing houses. In Europe, the Futures and Options Association (“FOA”) and ISDA have separately published an ISDA/FOA Addendum for use where a clearing member interfaces with a European CCP. Similarly, CCPs are making numerous changes to their rulebooks and related documentation to facilitate additional segregation and the clearing of new products. New requirements for swap dealers will require changes in ISDA and any other client-facing documentation for uncleared swaps.

Both dealers and buy-side market participants will need to review and reconfigure their OTC businesses and documentation in readiness for these changes. Dealers will need to refresh their client-facing documentation significantly in order to allow clearing. Buy-side participants, including hedge funds and corporates, may want to select a handful of clearing members with whom they deal, which could represent a change from past practices where they may have

<sup>3</sup> ESMA published a discussion paper on 12 July 2013 as a preliminary consultation on the regulatory technical standards to be published by it on the clearing obligation procedure under EMIR: <http://www.esma.europa.eu/content/Clearing-Obligation-under-EMIR>

executed derivatives with a larger number of counterparties. The new FIA/ISDA and ISDA/FOA Addenda will need to be tailored to the needs of particular dealers and clients.

Furthermore, various additional protocols have been developed by ISDA to facilitate compliance with EMIR and Dodd-Frank. These include the ISDA Dodd-Frank Protocols, which cover amendments required to facilitate compliance of dealers with the conduct of business and swap documentation requirements of Dodd-Frank; the NFC protocol, as noted above, under which a corporate will give comfort to a dealer that it has this status; and a reporting protocol facilitating authorisations and confidentiality consents necessary for the reporting of derivatives.

## Segregation

Both CCPs and (in the context of indirect clearing) clearing members will have to offer, at least in Europe and in the context of cleared derivatives, segregation of positions and assets on a *per client* basis. (This is despite some European states not yet recognising either the integrity of individual client positions or assets in insolvency laws.) Moreover, European collateral requirements for non-cleared swaps are likely to require full segregation of margin. In the US, the segregation requirements for customer collateral for cleared swaps, known as “LSOC” (legal segregation with operational commingling), came into effect on 9 April 2012. The LSOC regime is due to be enhanced to allow over-collateralisation of positions at CCPs (“LSOC with excess”), though the dates for these changes are currently uncertain. New segregation options will need to be offered for non-cleared swaps as well. Existing derivatives trading and clearing arrangements will need to be restructured to address the new segregation requirements.

One potential consequence of the various different collateral requirements is that clearing members and clients may use different collateral structures for cleared and non-cleared swaps in different countries, with consequential legal and operational risk implications.

Dealers will need to decide which of the plethora of different models for customer clearing they will support and at what cost. Buy-side participants will need to decide which levels of segregation they want or are prepared to pay for.

## Extraterritoriality

Both the new US and EU legislative regimes have an extraterritorial dimension in that they may capture OTC trades which are executed outside their jurisdiction. For example, EMIR will regulate trades that have been entered into between non-EU entities but which have a “direct, substantial and foreseeable effect” within the EU or where to do so is necessary to guard against anti-evasion. ESMA published a consultation paper on 17 July 2013 regarding the regulatory technical standards aimed at preventing the evasion of EMIR by non-EU counterparties<sup>4</sup>. This paper is open to consultation until 16 September 2013. It clarifies EMIR’s conditions on central clearing or risk mitigation applying to OTC derivatives by two non-EU counterparties which have the previously mentioned effect within the EU. The proposed standards would apply when two counterparties to a transaction are established outside the EU, the rules in their jurisdiction are not considered to be equivalent to EMIR and either: one of the counterparties is guaranteed by an EU financial counterparty; or both counterparties execute the transaction via their EU branches. There are also anti-evasion provisions requiring business substance and economic justification in the transaction.

<sup>4</sup> There will be a forthcoming publication from us on this ESMA consultation paper.

Similarly, Title VII of Dodd-Frank purports to apply to activities outside the US which have a “direct and significant connection with activities in, or effect on, commerce in the US”, where they are intended to evade US requirements or where a US person (a term that may include foreign companies) is involved. The US CFTC has issued final guidance and an interim exemptive order on the territorial reach of certain aspects of its rules, particularly those relating to Swap Dealer registration and the cross-border application of the related regulatory requirements. Notably, the CFTC has provided for a framework of substituted compliance with many of the Dodd-Frank requirements when entering into swap transactions with non-US branches of US Swap Dealers. The US SEC has also issued proposed guidance on this topic.<sup>5</sup>

The European Commission and the CFTC recently announced their agreed approach to cross-border derivatives for bilateral uncleared swaps and the trading execution requirement<sup>6</sup>. The CFTC and European Commission have stated that they will continue to work together to reach consensus on margins for uncleared swaps, straight-through-processing, adoption of mandatory clearing obligations, regulating intra-group derivative trades, reporting requirements and initial margins collected by CCPs.

Organisations or particular subsidiaries which have historically considered themselves not subject to either EU or US regulation may need to re-assess this and consider whether any steps should be taken, whether to avoid falling within the scope of new regulations, or to comply.

Dealers, funds and corporates will need to consider their most efficient business structure as the new rules evolve.

## Conclusion

It is vital that businesses carrying out derivatives transactions re-assess their processes and documentation to comply with these new reporting, conduct of business, clearing, collateral and segregation requirements in time for the approaching deadlines under the new regulatory framework

---

<sup>5</sup> For more on extraterritoriality, see our prior publications: [‘OTC Derivatives Regulation and Extraterritoriality’](#), [‘OTC Derivatives Regulation and Extraterritoriality II’](#) and [‘OTC Derivatives Regulation and Extraterritoriality III’](#).

<sup>5</sup> [http://europa.eu/rapid/press-release\\_MEMO-13-682\\_en.htm](http://europa.eu/rapid/press-release_MEMO-13-682_en.htm)