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## ISDA March 2013 Dodd-Frank Protocol (a.k.a. Dodd-Frank Protocol 2.0)

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**On March 22, 2013, ISDA published the March 2013 Dodd-Frank Protocol<sup>1</sup> (the “Protocol” or “Protocol 2.0”), which is designed to facilitate compliance with certain CFTC rules relating to clearing, portfolio reconciliation and swap trading relationship documentation.<sup>2</sup> The current deadline for compliance with these rules is July 1, 2013 and failure to complete Protocol 2.0 or enter into a substantially similar bilateral amendment addressing these requirements by the Adherence Deadline will likely result in swap dealers becoming unable or unwilling to enter into new swaps.<sup>3</sup> This client publication provides an overview of the Protocol’s structure and a summary of changes that the Protocol will make to existing agreements between Protocol participants.**

The operative provisions of the Protocol are found in the four schedules that comprise the ISDA March 2013 DF Supplement.

- Schedule 1 provides definitions;

<sup>1</sup> The full text of the ISDA March 2013 DF Protocol Agreement, the ISDA March 2013 DF Supplement and the ISDA March 2013 DF Protocol Questionnaire, can be found at: <http://www2.isda.org/dodd-frank-documentation-initiative/>.

<sup>2</sup> CFTC, Final Rule, Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55904 (Sept. 11, 2012). CFTC, Final Rule, Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74284 (Dec. 13, 2012) and CFTC, Final Rule, End-user Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42559 (July 19, 2012). This publication will focus on the use of the Protocol by swap dealers, although major swap participants are subject to the same rules and can also use the Protocol.

<sup>3</sup> The list of registered swap dealers can be found at: <http://www.nfa.futures.org/NFA-swaps-information/SD-MSP-registry.HTML>.

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- Schedule 2 covers a variety of CFTC rules, including, among other things, confirmations, clearing, and the end-user clearing exception;
- Schedule 3 provides a set of agreements intended to address the documentation requirements of the CFTC's risk valuation and dispute resolution regulations;
- Schedule 4 provides a set of agreements intended to address the documentation requirements of the CFTC's portfolio reconciliation regulations.

All parties automatically agree to Schedules 1 and 2 of the Supplement after they exchange questionnaires. Schedule 3 is mandatory for swap dealers, major swap participants and financial entities and Schedule 4 is mandatory for "**CFTC Swap Entities**," which is defined as registered swap dealers, major swap participants and persons that in good faith expect to shortly register as such.<sup>4</sup> All other parties have the option to agree to Schedules 3 and 4. When both parties have agreed to the same Schedules, then the relevant Schedules are deemed incorporated into the swap trading documentation between the parties. Schedules 3 and 4 will only be effective on July 1, 2013 unless the CFTC again delays the compliance date of the rules, in which case the later date will be the effective date. None of the Schedules will be effective unless one of the parties is a registered swap dealer or major swap participant. The parties can also use Protocol 2.0 to enter into a deemed 2002 ISDA Master Agreement.

### Why Is Protocol 2.0 Necessary?

Protocol 2.0 addresses a number of CFTC rules that are briefly described below. The Protocol is generally an efficient, industry wide solution to bring trading documentation into compliance with these regulations, but it is not mandatory and market participants can elect to address these regulatory requirements with their swap dealers on a bilateral basis. As a practical matter, however, given the volume of documents that swap dealers will need to amend before the Adherence Deadline, it is not likely that market participants will have time to bilaterally renegotiate their trading documentation. Market participants also have the option to do nothing, but this will likely result in a disruption of new trading activity following the Adherence Deadline. Note that ISDA's August 2012 Dodd-Frank Protocol<sup>5</sup> ("**Protocol 1.0**") addresses an entirely separate set of CFTC rules and completing that protocol does not impact the requirement to complete Protocol 2.0. There

<sup>4</sup> For further information regarding the terms "swap dealer" and "major swap participant" please refer to our publication on this topic, available at: <http://www.shearman.com/swap-dealer-major-swap-participant-and-eligible-contract-participant-sec-and-cftc-adopt-entity-definition-rules-07-13-2012/>.

<sup>5</sup> Despite sharing a similar format and adherence mechanic, Protocol 2.0 and Protocol 1.0 address entirely different sets of CFTC regulations and completing one will in no way satisfy the requirements of the other. Information on Protocol 1.0 can be found at: <http://www2.isda.org/functional-areas/protocol-management/protocol/8>.

will likely be additional protocols published to address additional CFTC and SEC rulemakings.

#### Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers

On August 27, 2012, the CFTC adopted final regulations setting forth requirements for swap confirmation, swap trading relationship documentation (“**STRD**”) and portfolio reconciliation for swap dealers. The CFTC has indicated that non-US swap dealers may not be required to comply with the STRD rules when transacting swaps with non-US persons, but the applicability of these rules to transactions involving non-US persons is currently in a state of flux, pending the release of the CFTC’s final cross-border guidance.<sup>6</sup>

*Swap Confirmation Rules:* The swap confirmation rules require swap dealers and major swap participants to execute confirmations of all swap transactions in which their counterparty is another swap dealer or major swap participant on the first business day following the execution date. For swap transactions with other types of counterparties, swap dealers and major swap participants must send an acknowledgement of the transaction on the first business day following the execution date, and would be required to have policies and procedures in place to confirm the swap transaction on the first business day following the execution date for financial entities, and on the second business day for all other counterparties.

*Swap Trading Relationship Documentation Rules:* The STRD rules require swap dealers and major swap participants to document all terms governing their trading relationship in writing, including terms related to credit support arrangements, swap valuation methodologies, and limitation of termination rights if a party becomes subject to a special resolution regime. Swap dealers and major swap participants are also required to document certain information related to clearing of their swaps and the qualifications of their counterparties to invoke the end-user clearing exception. Such information must be sufficient to provide the swap dealer or major swap participant with a reasonable basis to believe that its counterparty meets the statutory conditions required for an exception from a mandatory clearing requirement.

*Portfolio Reconciliation Rules:* Swap dealers and major swap participants are required to reconcile swap portfolios with other swap dealers or major swap participants with varying frequency, depending upon the size of the particular portfolio. Discrepancies in material terms identified as part of a portfolio reconciliation process must be resolved immediately and discrepancies in valuation must be resolved within one business day. For swap portfolios involving a counterparty that is not a swap dealer or major swap participant, swap dealers and major swap participants must establish written policies and procedures to perform portfolio reconciliation and to resolve any identified discrepancies in the material terms or valuation of swaps in a timely fashion.

#### ISDA March 2013 DF Protocol Master Agreement

The Protocol gives parties the option to elect to enter into a deemed 2002 ISDA Master Agreement to govern swaps (defined to include excluded FX swaps and forwards) that are not (i) governed by an existing master agreement or (ii) agreed by the parties to be cleared on a derivatives clearing organization. The deemed 2002 ISDA Master Agreement has certain predetermined elections made to its schedule. The ISDA will be governed by New York law, multiple payment

<sup>6</sup> For further information regarding the CFTC’s cross-border guidance please refer to our publication on this topic, available at: <http://www.shearman.com/cftc-issues-final-exemptive-order-temporarily-limiting-cross-border-application-of-the-swaps-provisions-of-the-dodd-fra-act-12-28-2012/>.

transaction netting will be applicable for FX Transactions and Currency Option Transactions only, and if the parties have completed Protocol 1.0, then this agreement will be supplemented per the terms of that protocol.

Where no ISDA Master Agreement is currently in place, this deemed ISDA permits the parties to satisfy certain portions of the STRD rules. However, because ISDA Master Agreements tend to be highly customized and heavily negotiated, many market participants that do not currently have an ISDA Master Agreement in place may prefer to negotiate their own agreement rather than enter into the default ISDA March 2013 DF Protocol Master Agreement.

### Mandatory Clearing

On December 13, 2012, the Federal Register published the CFTC's first clearing determination for "plain vanilla" fixed for floating interest rate swaps, forward rate agreements and basis swaps in US dollars, Euro, Sterling or Yen, and CDX and iTraxx index credit default swaps. The CFTC is phasing in compliance with this clearing requirement by dividing market participants into three categories and requiring the most active market participants to begin clearing first. The three categories of market participants are "Category 1 Entities," "Category 2 Entities," and "Category 3 Entities". In combination with Protocol 1.0, Protocol 2.0 permits swap dealers to obtain the necessary representations about when their counterparties become subject to this mandatory clearing requirement.

Category 1 Entities include swap dealers, major swap participants and active funds, and these entities were required to begin clearing swaps with other Category 1 Entities on March 11, 2013.<sup>7</sup> Category 2 Entities generally include other financial entities, other than certain employee benefit plans and separately managed accounts, and these entities will be required to begin clearing swaps with Category 1 Entities or Category 2 Entities on June 10, 2013.<sup>8</sup> Category 3 Entities (i.e., all other market participants) will have to begin clearing on September 9, 2013, unless they are able to take advantage of a clearing exception or exemption.<sup>9</sup>

### End-User Clearing Exception

Commercial end-users have been granted an optional exception from the mandatory clearing and trading requirement when certain conditions are met. The exception is available if the end-user is not a financial entity, the swap is being used to hedge or mitigate commercial risk, and the end-user satisfies its reporting obligations to the CFTC, including how it generally meets its financial obligations for non-cleared swaps.<sup>10</sup> The Protocol allows swap dealers to obtain representations from end-users to confirm that the swap is not required to be cleared and to ensure that the reporting obligations are properly complied with.

<sup>7</sup> An active fund is a "private fund," as defined in Section 202(a) of the Investment Advisers Act of 1940, that (i) is not a third-party subaccount and (ii) has executed 200 or more swaps per month on average over the 12 months preceding November 1, 2012.

<sup>8</sup> Category 2 Entities include (i) a commodity pool as defined in Section 1a(10) of the CEA and CFTC Regulations thereunder, (ii) a "private fund," as defined in Section 202(a) of the Investment Advisers Act of 1940 other than an Active Fund, or (iii) a person predominately engaged in activities that are in the business of banking, or in activities that are "financial in nature," as defined in Section 4(k) of the Bank Holding Company Act of 1956, provided that, in each case, the entity is not a third-party subaccount.

<sup>9</sup> There is an extended clearing timeline for iTraxx index credit default swaps. Category 1 Entities must begin clearing of such swaps by April 26, 2013, Category 2 Entities must begin clearing of such swaps by July 25, 2013 and Category 3 Entities must begin clearing of such swaps by October 23, 2013.

<sup>10</sup> For further information regarding the End-User Exception please refer to our end-user handbook, available at: <http://www.shearman.com/a-corporate-end-users-handbook-for-dodd-frank-title-vii-compliance-10-03-2012/>.

## Protocol Architecture

Protocol 2.0 is structurally identical to Protocol 1.0, so market participants that have already completed Protocol 1.0 will be familiar with the elements of the Protocol, which are:

- the ISDA March 2013 DF Protocol Agreement (“**Protocol Agreement**”);
- the ISDA March 2013 DF Protocol Adherence Letter (“**Adherence Letter**”);
- the ISDA March 2013 DF Protocol Questionnaire (“**Questionnaire**”);<sup>11</sup> and
- the ISDA March 2013 DF Supplement (“**Supplement**”).

Signing the Adherence Letter indicates a person’s intention to complete the protocol process by exchanging Protocol Questionnaires with its counterparties that have also submitted signed Adherence Letters. The Supplement contains the substantive provisions of the Protocol and these provisions only become effective upon an exchange of Questionnaires between counterparties. Using the Questionnaire, the parties will elect which portions of the Supplement they intend to incorporate into their swap documentation (e.g. ISDA Master Agreement) (“**Protocol Covered Agreement**”).

## What Does Protocol 2.0 Do?

*March 2013 DF Supplement Information:* Both parties represent that the information they provide in the Questionnaire is accurate and agree to promptly update such information if it changes or becomes misleading or false.

*Swap Confirmation:* Both parties agree that unless they have otherwise agreed in writing, confirmations can be created by both parties exchanging matching written trade terms. This provision does not override any confirmation method that the parties have agreed in writing elsewhere (e.g. Section 9 of an ISDA Master Agreement).

*Mandatory Clearing:* Instead of asking market participants to potentially remake the Category 1 and Category 2 representations that they were asked to make in Addendums 1 and 2 of Protocol 1.0,<sup>12</sup> Protocol 2.0 instead includes a set of deemed representations. For example, if a person enters into a trade subject to mandatory clearing during a period when only such swaps between two Category 1 Entities are required to be cleared, but does not provide clearing instructions or provide another explanation for why clearing is not required, then that person will be deemed to represent that it is not a Category 1 Entity. Similarly, if a person enters into a trade subject to mandatory clearing during a period when only such swaps between Category 1 or 2 Entities are required to be cleared, but does not provide clearing instructions or provide another explanation for why clearing is not required, then that person will be deemed to represent that it is neither a Category 1 nor a Category 2 Entity. These deemed representations shift the notification burden, and potentially the regulatory liability, to non-swap dealers.<sup>13</sup>

<sup>11</sup> While ISDA has published a version of the Questionnaire that can be completed and physically exchanged, most market participants will likely opt to use the ISDA Amend platform that Markit has created for exchanging and matching Questionnaires, available at <http://www.markit.com/en/products/distribution/counterparty-manager/isda-amend.page>.

<sup>12</sup> Protocol 1.0 permits market participants to represent that they are swap dealers, major swap participants, or active funds (i.e. Category 1 Entities) or “Category 2 Entities.”

<sup>13</sup> 17 C.F.R. pt. 50.25(a).

In light of these deemed representations and to the extent they have not already done so, Protocol adherents will want to determine if they are a Category 1 or 2 Entity and alert their swap dealers if they meet either definition. These representations may have been provided using Protocol 1.0, but because these questions were only added to the questionnaire in Addenda to the original Protocol 1.0, early adherents may need to revisit Markit's ISDA Amend<sup>14</sup> and update their questionnaires. These deemed representations will not apply to persons not subject to the clearing requirement because of the end-user clearing exception or other CFTC guidance, including, but not limited to, the CFTC's final order granting temporary relief from clearing for non-US persons under certain conditions.<sup>15</sup>

*End-User Clearing Exception:* The end-user clearing exception exempts commercial end-users from the CFTC's mandatory clearing determinations so long as certain conditions are satisfied. One of the conditions is that the use of the end-user exception is reported to a swap data repository, which can be done either on a trade by trade basis or on an annual basis. The end-user can either make an annual report itself, or it can alert its swap counterparty that no such annual report has been made in the last 365 days prior to entering into the swap and then provide the swap dealer with all the information required to submit the report for that particular trade. End-users that give notice that they are not clearing in reliance on the end-user exception represent that they are eligible to use the exception and that they have submitted the annual notice itself, or alternatively that they have provided all of the information to a swap dealer. Swap dealers represent that information given to them on a trade by trade basis will be reported to a swap data repository.

The Questionnaire offers parties eligible to use the End-User Exception the ability to make a standing election to do so, unless it instructs the swap dealer to the contrary. Regardless of whether the standing election is made, the Protocol deems any party electing to use the End-User Exception to represent that they have satisfied their reporting requirement using an annual filing unless they have notified their swap dealer that this is not the case. The Questionnaire offers parties the ability to provide this notification. The Questionnaire asks parties that will not be making the annual filing to provide their swap dealers with the information necessary for the swap dealer to satisfy the reporting requirement on a trade by trade basis.

*Orderly Liquidation Authority:* If a counterparty is a financial company<sup>16</sup> then in a scenario where the company faces failure, there is a risk of the FDIC being appointed receiver under the Orderly Liquidation Authority ("**OLA**") created by the Dodd-Frank Act. If the company is put into OLA, notwithstanding any agreement between the parties, the FDIC, subject to certain conditions, may transfer the agreements to another party. In this case, termination netting and termination provisions triggered by the company entering an insolvency proceeding may not be enforceable. For example, "qualified financial contracts" ("**QFCs**") are subject to a one-day "stay" when the FDIC is appointed as receiver under the OLA. The OLA's approach to QFCs mirrors the approach to QFCs under the Federal Deposit Insurance Act with respect to the FDIC acting as receiver for an insured depository institution.<sup>17</sup> In order to monitor and assess the risk of a company

<sup>14</sup> Go to ISDA Amend at <http://www.markit.com/en/products/distribution/document-exchange/registration.page> and complete the Questionnaire and permission counterparties to receive the Questionnaire.

<sup>15</sup> For further information regarding this order please refer to our publication on this topic, available at: <http://www.shearman.com/cftc-issues-final-exemptive-order-temporarily-limiting-cross-border-application-of-the-swaps-provisions-of-the-dodd-frank-act-12-28-2012/>.

<sup>16</sup> 12 U.S.C. § 5381(a)(11).

<sup>17</sup> 12 U.S.C. § 1813.

entering OLA, both parties agree to alert the other party if there is any reason to believe that there is any change in their own status as a financial company that could be subject to OLA.

The OLA was created by the Dodd-Frank Act to create a mechanism for liquidating “financial companies,” which includes entities such as bank holding companies and systemically important nonbanks designated by the Financial Stability Oversight Council (insured depository institutions are not covered by the OLA). The OLA is intended to solve the “too-big-to-fail” problem by ensuring that there is a mechanism to resolve a failing financial company without risking systemic consequences across the financial system and the broader economy. The FDIC, which would be the receiver of a financial company subject to the OLA, has been developing a strategy for a resolution under this new framework. However, it is not clear that the FDIC’s strategy would be viable if a large, complex financial institution faced failure today.

*Risk Valuation and Dispute Resolution:* Schedule 3 is mandatory for swap dealers, major swap participants and financial entities. The risk valuation and dispute resolution provisions were intended to come into effect after the CFTC issued mandatory margin requirements for uncleared swaps, but the CFTC has not yet issued such requirements. Consequently, these provisions are exclusively for the purpose of allowing swap dealers to comply with the CFTC’s risk management requirements. The Protocol goes to great lengths to clarify that no valuation procedure or dispute mechanism will replace or amend any such procedure or mechanism (including with respect to trade or collateral valuation) that the parties have otherwise agreed to.

Schedule 3 provide that the swap dealer will calculate the value of the swaps between the parties using the process agreed to in the credit support annex (“**CSA**”), if any, acting in good faith and using commercially reasonable procedures in order to produce a commercially reasonable result. If no CSA exists, then the swap dealer will calculate the amount payable as if the trades were being terminated in accordance with the close-out mechanics in their ISDA, and if no close-out mechanics were agreed, then the swaps will be valued in accordance with the 2002 ISDA Master Agreement’s Close-out Amount method. The swaps will generally be valued at mid-market prices.

In contrast to a typical CSA, the swap dealer’s counterparty has the option to perform its own calculation under the provisions of the CSA and deliver the calculations to the swap dealer, who can then use these calculations if it determines in good faith that the calculations satisfy the CFTC’s requirements. Counterparties can request notification of the swap dealer’s valuations.

A counterparty to a swap dealer will have one joint business day to dispute the valuations and must provide their own calculations, calculated in good faith and using commercially reasonable procedures in order to produce a commercially reasonable result. Any previously agreed CSA dispute mechanisms shall be used to resolve the dispute, but where no such dispute mechanisms exist, a default dispute resolution provision shall apply and will look to mid-market quotations obtained from market-makers.

*Financial Entity Ambiguity:* Schedule 3 is mandatory for “financial entities” defined as a person that is a financial entity as defined in Section 2(h)(7)(C)(i) of the CEA,<sup>18</sup> without regard to the small bank exclusion<sup>19</sup> or the captive finance

<sup>18</sup> Section 2(h)(7)(C)(i) of the CEA defines a “financial entity” for purposes of mandatory clearing as (i) a swap dealer, (ii) a security-based swap dealer, (iii) a major swap participant, (iv) a major security-based swap participant, (v) a commodity pool, (vi) a private fund as defined in Section 202(a) of the Investment Advisors Act of 1940, (vii) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the

company limitation.<sup>20</sup> Protocol 2.0's expansion of the CEA's financial entity definition is potentially problematic for small banks and captive finance companies, because Protocol 2.0's financial entity representation is deemed an update to Protocol 1.0's financial entity representation, but does not make any provision of the CFTC's different financial entity definitions. The CFTC considers small banks and captive finance companies to be financial entities for purposes of the CFTC's confirmation and STRD rules, but non-financial entities for purposes of the CFTC's clearing and swap data repository reporting rules. Protocol 2.0's financial entity definition generally tracks the definition used for the CFTC's confirmation and STRD rules.<sup>21</sup> Protocol 1.0's financial entity definition generally matches the definition used for the CFTC's clearing and swap data repository reporting rules.<sup>22</sup> Because Protocol 2.0's financial entity representation overrides Protocol 1.0's representation, if these entities follow Protocol 2.0's instructions, small banks and captive finance companies will represent that they are financial entities for purposes of swap data repository reporting. This may result in inaccurate swap data repository reporting and create significant confusion for small banks and captive finance companies completing the questionnaire.

*Portfolio Reconciliation:* Schedule 4 is mandatory for CFTC Swap Entities. If Schedule 4 is applicable, then swap dealers have the right to demand a portfolio reconciliation upon notice to the counterparty and at the intervals required by the CFTC rules. Portfolio reconciliation can be accomplished in one of two ways. First, if both parties are CFTC Swap Entities or both parties have agreed to mutual exchange of portfolio data, then the parties will exchange and compare the material terms and valuations of the swaps between them. Second, if only one party is a CFTC Swap Entity and the parties have agreed to one-way delivery of portfolio data, then the swap dealer will deliver the data to the other party which will then review and compare the material terms and valuations of the swaps against its own books and records. In all cases, the parties agree to alert their counterparty of any discrepancy, except that if the valuation discrepancy is less than 10% of the larger of the two calculations, no notification obligation exists.

The parties can agree to reconcile the material terms of the swaps against the data from a swap data repository to the extent possible, but either party can unilaterally demand full portfolio reconciliation upon two joint business days' notice.

## Consequences of a Misrepresentation or Breach

The Protocol explicitly provides that a breach of any representation, covenant or agreement contained exclusively in the Protocol will not result in an event of default, termination event or other similar event that gives a party the right to terminate a swap. However, the Protocol is equally clear that if an identical representation, covenant or agreement is contained elsewhere in the Protocol Covered Agreement, then this limitation will not affect the parties' remedies under

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Employee Retirement Income and Security Act of 1974, and (viii) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956.

<sup>19</sup> CEA § 2(h)(7)(C)(ii) and 17 C.F.R. pt. 50.50(d).

<sup>20</sup> Protocol 2.0's definition of financial entity is: (i) a swap dealer, (ii) a security-based swap dealer, (iii) a major swap participant, (iv) a major security-based swap participant, (v) a commodity pool, (vi) a private fund as defined in Section 202(a) of the Investment Advisors Act of 1940, (vii) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974, and (viii) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956.

<sup>21</sup> 17 C.F.R. pt. 23.500(e).

<sup>22</sup> CEA § 2(h)(7)(C)(iii).

the Protocol Covered Agreement. Additionally, the Protocol is an agreement between the two adhering parties and a breach any of the Protocol's representations, warranties and covenants may give rise to common law remedies.

## Conclusion

Most market participants will likely find the Protocol to be the simplest and most efficient method for bringing their swap documentation into compliance with the CFTC's STRD rules and obtaining the necessary representations related to mandatory clearing and the end-user clearing exception. As market participants begin to adhere, swap dealers will likely begin to form policies regarding certain issues, such as the election of Schedules 3 and 4. We will continue to keep clients updated on any regulatory developments.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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