Compliance Considerations for Derivatives End-Users

A "How To Guide" to Basic Derivatives and Structured Products

Presentation to the New York City Bar

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Dodd-Frank Protocol

- ISDA's August 2012 DF Protocol adherence letter or other similar documentation must be entered into
  - Amends swap agreements to comply with new swap dealer rules that take effect May 1, 2013
    - On December 18, the CFTC extended go-live date from January 1 to May 1 – Happy Holidays!
  - Business conduct standards compliance date is May 1, 2013
    - Heightened pre-transaction due diligence and KYC
    - Special entity requirements (Munis, ERISA Pension Plans)
  - End-users that have submitted adherence letters and paid fees are posted at www.isda.org

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Clearing

- Mandatory clearing is designed to level playing field between swap dealers and end-users
- Benefits: in cleared swaps, swap dealers required to:
  - disclose counterparty material information
  - provide scenario analysis that cover range of assumptions
  - upon request, provide written statement of all terms, other than pricing and other terms to be agreed to at the trade
  - possibly post collateral to end-users
- New regulatory environment tightens capital and margin requirements

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Clearing – End-User Exception

- Exception for mandatory clearing by end-users
- Not required until CFTC mandates clearing of swaps by clearinghouses
- End-user election of the exception must be made
- Requirements:
  - Purpose of swaps is to hedge or mitigate commercial risk
    - Supported by contractual obligation or business need that is economically appropriate (eg, airline hedging fuel costs)

Clearing- End User Exception (cont.)

- End-User Election Requirements (cont.)
  - Provide information of trade and exception to a swap data repository
    - By trade or on yearly basis; must document reasonable basis for not clearing as determined by Board of Directors or Suitable Governance Committee
  - End user cannot be a financial entity
    - Includes swap dealers, private funds, banks, employee benefit plans or government plans

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Important: Understand the Product

- <u>It is critical that you fully understand a derivative product prior to purchasing it</u>
- Questions to Ask Your Financial Institution Prior to Entering Into a Derivatives Transaction:
  - How does the product work?
  - What are the variables that might cause volatility?
  - What is the method of completing the transaction (eg., confirmation, contract, other)
  - What assumptions have been made in calculating potential my cost savings?
  - How does the bank hedge its risk?
    - Will participations in the risk be sold to other financial institutions?

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Understand the Product (cont.)

- Questions to ask your financial institution (cont.)
  - Will the bank or the company be creating a short position in the company's stock?
  - Is it an option or a forward?
    - Will I owe an upfront premium? (option)
    - Am I committed to purchasing securities or delivering additional cash at a later date? (forward)
    - If I am using the derivative to deliver cash, stock or commodities on a specific date or for a specific occasion (eg, M&A closing), will this product give me flexibility in case timing is accelerated or slips?
  - How will the company's stock trading be affected by the transaction?

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Understand the Product (cont.)

- Questions to ask your financial institution (cont.)
  - Will I have to report this as an off-balance sheet transaction? (involve financial reporting team and auditors)
  - If the trade starts to move against me, does the trade allow me to novate into a new trade (eg, a “blend and extend” or “rate rollover” transaction)
    - If I sign a novation will I still have to pay the mark-to-market differential at the time?
  - Will I have to post collateral or additional collateral? If so, under what circumstances?
  - Have you written similar trades for similar companies?
  - What else can go wrong?/What questions would you ask?

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