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ViewPoint
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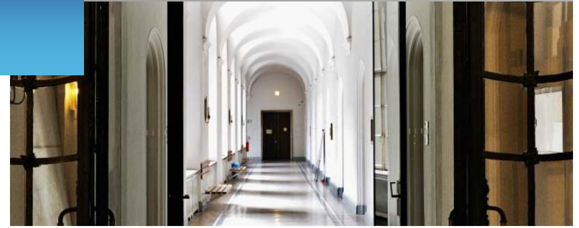
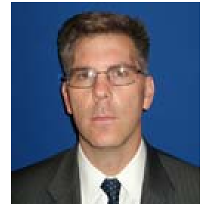
# Start the Countdown – Implementation of Swaps Clearing in the US



When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in July 2010, it set an ambitious schedule for the implementation of its reforms, giving the agencies charged with promulgating rules – the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") – one year following the date of enactment to do so. More than two years later, while much attention has been given to the number of missed deadlines for new rules, mandatory clearing for interest rate swaps ("IRS") and index credit default swaps ("CDS") now has real deadlines and industry participants are in various stages of preparedness. Even though some rules remain in the proposed stage, market participants should develop their plans to meet this requirement. This *ViewPoint* focuses on those necessary steps, with an emphasis on what the clearing mandate means for institutional investors in the US markets.

*Joanne Medero, Managing Director, is a member of the Government Relations Group*



*Richard Ostrander, Managing Director, manages legal coverage of trading and derivatives within Legal & Compliance*

## Background

One of the central planks of over-the-counter ("OTC") derivatives reform in Dodd-Frank was a requirement that all swaps that could be cleared, should be cleared through a central clearing party-or in the term used in Dodd-Frank, a CFTC or SEC "derivatives clearing organization" ("DCO"). In order to get to this result, Congress delegated to the agencies numerous rule-making responsibilities, including:

- establishing rules for the DCOs (including risk management and governance);
- determining the parameters of what derivatives are to be cleared;
- requiring registration and setting internal and external business conduct rules for swaps dealers; and
- defining which financial instruments are "swaps" and thus within the ambit of the reforms.

For CFTC regulated swaps, the essential rules are now in place, and the clearing mandate will begin as soon as January 2013 for transactions occurring between certain market participants (i.e., swap dealers, major swap participants and "active funds") and will be effective no later than August 2013 for swaps involving asset management clients [see Exhibit 1 for description of which swaps are regulated by which agency]. Many institutional investors as part of their counterparty risk management strategy have decided to clear before the mandate becomes effective.

The approach to implementation of the clearing mandate, as well as other Dodd-Frank reforms, differs between the CFTC and the SEC. The CFTC has taken an approach from the beginning of its rule-making efforts to link the effective date of its new rules to the final enactment of the definition of swap, generally 60 days after this rule is officially published. The SEC, on the other hand, has proposed "sequencing" guidance that is premised on certain rules being enacted in a particular order, and only when their rule-making is substantially complete will the clearing mandate become effective.

*The opinions expressed are as of September 2012 and may change as subsequent conditions vary.*

Two important milestones were recently reached. On August 13th, the CFTC and SEC officially published their joint rule defining what is a "swap" and what is a "securities-based swap". The publication of the final rules triggered the deadlines for compliance with many CFTC regulations and starts the SEC's sequence for finalizing its derivatives rules. Additionally, on August 7th, the CFTC published its proposed clearing determinations for IRS and index credit default swaps, which it has up to 90 days to finalize. Swap dealers will need to register with the CFTC by year-end and the clearing mandate "phase-in" will begin for IRS and CDS as soon as the clearing determinations are final [see Exhibit 2 for a timeline]. It is important to note that swap dealers, once registered, will have to comply with a number of new rules governing such things as swap reporting and recordkeeping, conflicts of interest policies, and external business conduct standards.

External business conduct standards require, among other things, that the dealer receive certain information and representations from its non-dealer counterparties. This flows through to institutional investors who use swaps in their strategies, including asset managers as agents for their clients, and in some cases will affect the content of investment management agreements.

**Exhibit 1: Which Agency Regulates What?**

**SEC**

- Regulates "securities-based swaps", which include swaps whose reference price is linked to:
  - single securities (including single name CDS and total return swaps on single equities);
  - narrow based securities indices; or
  - options on securities

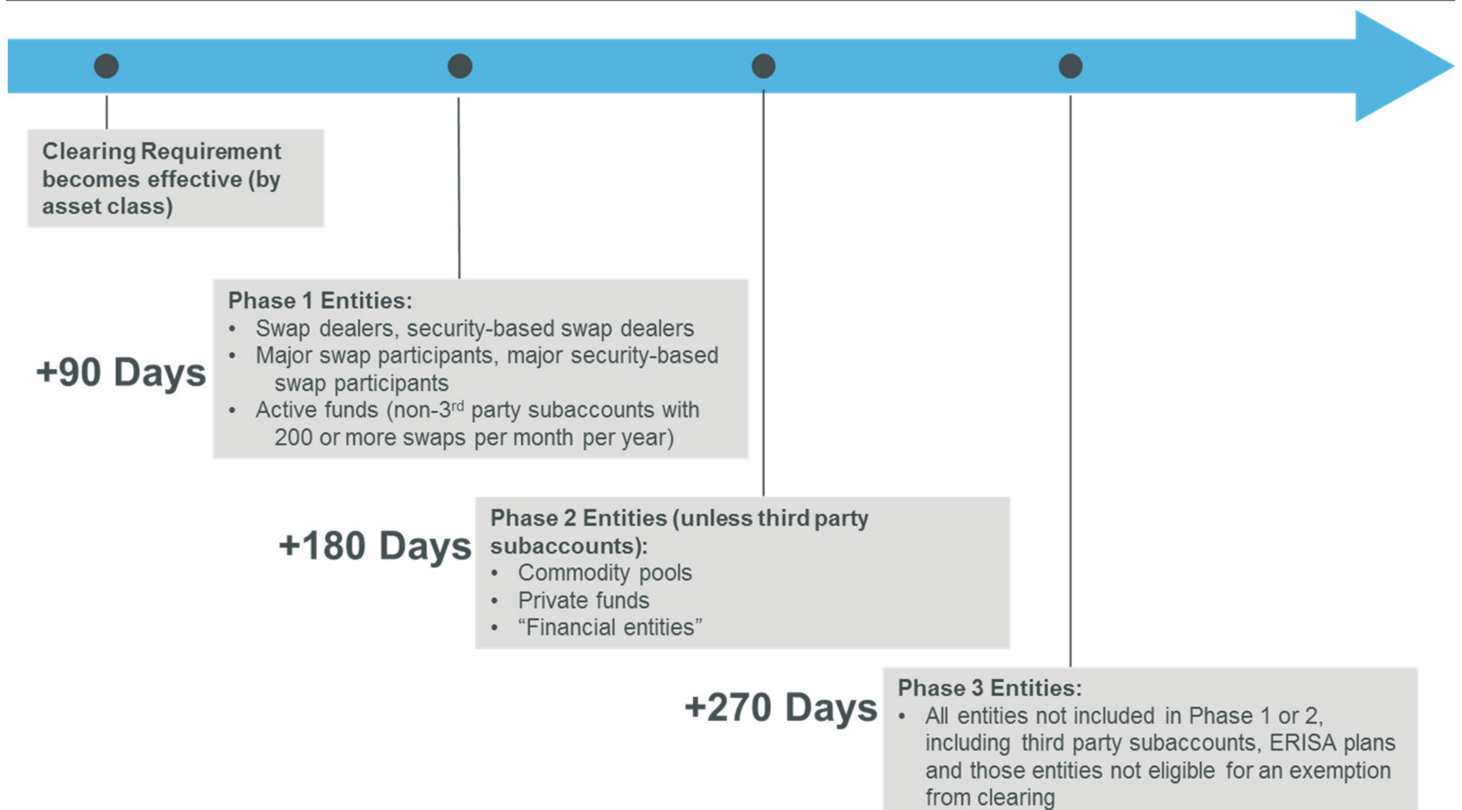
**CFTC**

- Regulates "swaps", which include swaps whose reference price is linked to:
  - Commodities and interest rates;
  - broad based securities indices; or
  - foreign exchange (except FX as excluded from regulation by a determination of the Secretary of the Treasury)

**U.S. Treasury**

- Has preliminarily determined to exclude from regulation as "swaps" forward FX transactions involving the physical exchange of a single currency for another (e.g., USD for Euros)
- As of September 2012 this determination is not final

**Exhibit 2: CFTC Phase-In of Clearing Mandate**



The CFTC has by rule established a phase-in for compliance with the mandatory clearing requirement that is based on swap category and the type of market participant. For each type or class of swap, the CFTC will first make a determination that the swap is eligible for clearing, based on submissions by the DCOs. When that determination is final, the phase-in rule sets out different compliance periods based on the type of market participant [Exhibit 2]. It is important to note that the financial end-user category for purposes of the phase-in requirement includes private funds, commodity pools, and banks and other financial companies (that are not swap dealers). Pension plans are given 270 days based on concerns raised by plans that to the extent they both participate in direct investing (where a plan would be considered a Phase 2 financial end-user) and use external managers (where a plan would be considered a Phase 3 third party subaccount), they would have two different compliance periods.

## Steps to Clearing

The primary purpose of central clearing is to reduce counterparty risk and, as such, reduce systemic risk. When swaps are cleared, the DCO collects initial and variation margin from swap counterparties and, by stepping into the middle of the trade, substitutes its credit for the credit of each of the counterparties, thus becoming the central counterparty for all swaps at the DCO. DCO financial integrity is overseen by the CFTC and the SEC, and, as designated "financial market utilities" under Dodd-Frank, the major DCOs are also subject to further oversight by the Federal Reserve.

Under Dodd-Frank, all customer positions and related collateral must be held by or through a CFTC registered futures commission merchant ("FCM"). All customer property must be segregated from that of the FCM. Customer property as held by an FCM or DCO is subject to specific rules promulgated by the CFTC addressing eligible investments for these funds. In addition, the rules provide that in the event of an FCM bankruptcy that customer property related to swaps will be protected. In advance of the CFTC's clearing mandate becoming effective, institutional investors will need to ensure that they have access to a clearing house, either directly through a clearing house member or an FCM that has a relationship with a clearing member. Clearing house members are themselves also FCMs. It may be prudent to establish a relationship with more than one clearing member or FCM.

For commingled funds and separate account investors who permit their investment manager to execute their trading documentation, the investment manager will set up these relationships on behalf of the fund or client. Separate account investors who execute their own trading documents will need to execute various agreements relating to swaps with the FCM, including a futures agreement with an OTC addendum for cleared swaps. It will be important to allow sufficient time for the parties to complete negotiations and execute the agreements before the clearing mandate is effective. Changes to existing bi-lateral agreements documented under International Swaps and Derivatives Association ("ISDA") forms will likely be necessary to reflect new regulations and required representations. ISDA has launched a new protocol that will, for most market participants, provide a simplified mechanism for these modifications. For some institutional investors that to date have only entered into certain bi-lateral swaps, the posting of initial and variation margin will be new, and these investors should take steps to be operationally ready to manage these cash movements (and related valuation calculations) either directly or by assuring that their investment managers and their custodians are prepared to do so.

Both for reporting of swap transactions and for clearing, all swap market participants will need to obtain a "legal entity identifier" ("LEI") for all entities (including funds) engaging in swaps. Further information on LEIs is set out in Exhibit 3.

**Exhibit 3: What is an LEI?**

Dodd-Frank requires swap transactions when executed to be reported to Swap Data Repositories ("SDRs"). Terminations and all other "life cycle" changes will also be reported. This reporting requirement will become effective based on type of counterparty and asset class, with the IRS and CDS involving swap dealers or major swap participants becoming subject to the requirements this Fall.

To facilitate this tracking, all market participants will need to be assigned a "Legal Entity Identifier" for each of their legal entities that transact in swaps. For institutional investors and asset managers this means each individual fund or trust will require an LEI. Current guidance is that institutional investors would not get a separate LEI for each account managed by different managers, unless the account was established as a separate legal entity. Although certain trade execution data will be publicly available, the LEI will only be known to the SDR and regulators.

In August 2012, DTCC and SWIFT launched a website [www.ciciutility.org] for market participants to obtain a "CFTC interim compliant identifier" ("CICI") which will facilitate reporting compliance until the LEI system is in place. Currently the use of a CICI or LEI is a US requirement, but is expected to be implemented globally.

## Impediments to Clearing Remain

While the challenges of getting legal documentation in place and being operationally ready are significant, there remain several regulatory issues to be resolved before mandatory clearing can be fully implemented.

The customer protection regime for cleared swaps collateral, commonly referred to as "LSOC", for "legally separate, operationally commingled", is to be effective on November 8, 2012, but since it is new (and different from what is currently in place for futures), there are several issues to be worked out between market participants and the DCOs to ensure that LSOC

works as expected by institutional investors. Among other things, this involves the appropriate treatment and protection of both customer variation margin and excess margin in the event of a clearing member, FCM bankruptcy. We are confident these issues can be resolved if not by the industry, then by the CFTC, which is actively engaged in these discussions. Given the recent failures of MF Global and Peregrine Financial Group, the protection of customer collateral is of paramount importance.

Additionally, there are requests pending with the Department of Labor ("DoL") to confirm that clearing member FCMs should not be considered ERISA fiduciaries when engaging in certain activities related to pension plan cleared swap positions. Similar comfort was provided to FCMs in relation to futures in the early 1980s. Confirmation that the same or similar analysis applies to cleared swaps or the issuance of an exemption (if it is determined that the FCM is a fiduciary) will be necessary before ERISA plans will, as a practical matter, be able to clear their swap transactions. We are concerned that if the DoL chooses the exemption route, it will be difficult to complete the exemption process in time and the conditions imposed on the exemption may create an impediment to ERISA plans clearing swaps. In the absence of this guidance, ERISA plans will not be able to enter into new swaps that are subject to the clearing mandate.

## Conclusion

One of the central tenets of Dodd-Frank was to reduce systemic risk. From the outset of this discussion, BlackRock has supported central clearing as an important part of the solution. BlackRock has also been a vocal advocate of the need to protect customer collateral. As the various rules have been put into place in the US, mandatory clearing through a DCO looks attainable. We expect Europe and some markets in Asia to similarly establish final rules for central clearing. These developments will require significant change for all market participants, and it will be important to address the impediments noted.

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