

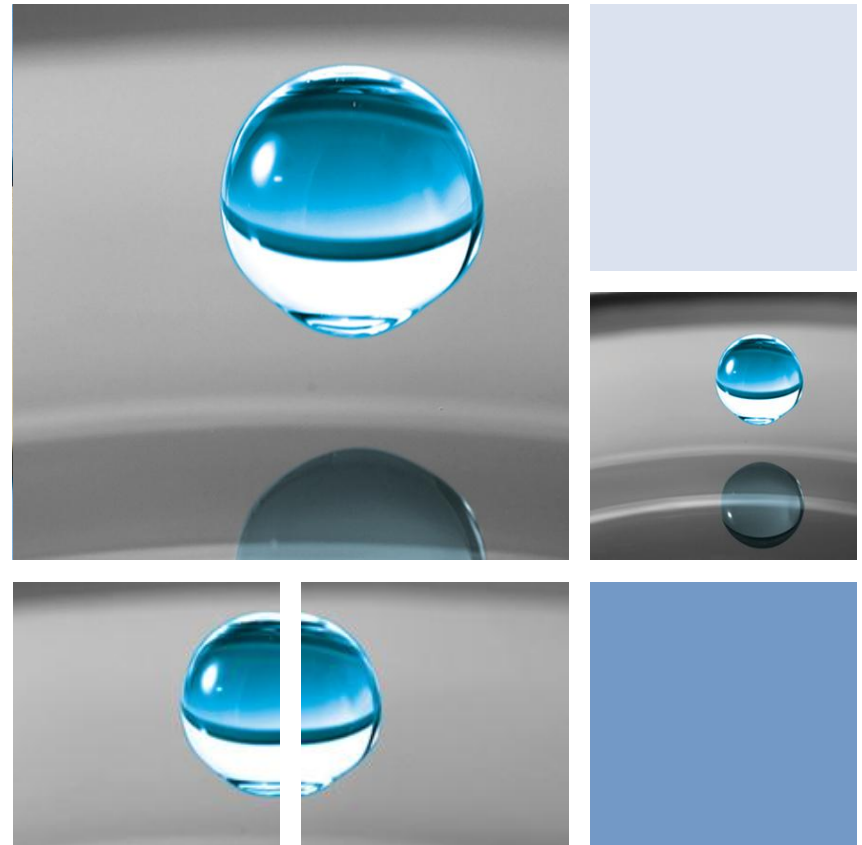
# Dodd Frank - Impact to the FX Market Participant

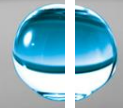
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April 26 2013

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Several U.S. regulators have authority over the swaps market and as a result different rules will attach to transactions depending on both product and counterpart

### CFTC “swaps”

*(Implementation underway)*

- 1. All rate swaps, rate options, rate exotics
- 2. Swaps on “exempt securities” (e.g. UST’s)
- 3. All commodity swaps
- 4. Non-qualifying commodity forwards
- 5. NDFs, Currency swaps, FX Options
- 6. Broad-based equity & debt index swaps
- 7. Broad-based index CDS
- 8. Multi-loan TRS

### SEC “security-based swaps”

*(Awaiting rule finalization)*

- 1. Narrow-based Equity & Debt Index Swaps
- 2. Single Name Equity & Debt Swaps
- 3. Single Loan TRS
- 4. Single Name CDS
- 5. Narrow-based Index CDS

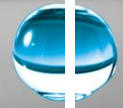
### Mixed Swaps

A “Mixed Swap” has underlyers and/or features that could classify it as regulated by both CFTC and the SEC

# Scope: Application of Select DF Requirements to FX



	External Business Conduct	SDR Reporting	Real Time Reporting	Mandatory Clearing	Mandatory SEF Trading	Margin
FX Spot	X	X	X	X	X	X
FX Forward	✓	✓	X	X	X	X
FX Swap	✓	✓	X	X	X	X
FX Options	✓	✓	✓	✓	✓	✓
NDFs	✓	✓	✓	✓	✓	✓
Cross-Currency Swaps	✓	✓	✓	✓	✓	✓
Rule Status	Final	Final	Final	Final	Proposed	Proposed



## Scope of Exemption:

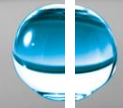
- Narrowly tailored to cover just physically settled foreign exchange swaps and foreign exchange forwards.

**Foreign Exchange Forward.** The term “foreign exchange forward” means a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange.

**Foreign Exchange Swap.** The term “foreign exchange swap” means a transaction that solely involves:

- An exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and
  - A reverse exchange of the 2 currencies described in preceding subparagraph at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange.
- FX swaps and forwards remain subject to external business conduct rules and trade reporting requirements. Additionally, reference is made in the Treasury Determination to certain other business conduct standards, including the Confirmation, Portfolio Reconciliation, Portfolio Compression and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants.

# General Regulatory Framework



GENERAL

AT INDIVIDUAL TRADE LEVEL

**NEW business conduct standards**

- New suitability obligations
- Enhanced Know Your Customer (“KYC”) requirements
- Special Entity Status
- Documentation Requirements

**NEW pre-trade requirements**

- Material Economic Terms” (“MET”)
- “Dodd-Frank Mid” (“DF Mid”)
- “Dodd-Frank Mid Methodology”
- “Scenario Analysis” (upon request)
- “Material Risk Disclosures”

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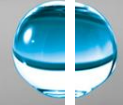
**NEW post-trade requirements**

- Reporting of trades (both to the public and the regulator)
- Faster confirmation processing
- Mandatory clearing
- Compressions
- “Daily Mark”

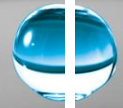


- **Swap Dealers must verify that each counterparty is an “eligible contract participant”**
  - Swap dealers need a written representation from a counterparty specifying how it qualifies an ECP
  - “Look through” test for commodity pools engaged in FX transactions requires the satisfaction of one of the following conditions:
    - Confirmation that all underlying direct investors are ECPs;
    - AUM of more than \$10mm and a registered CPO, unless otherwise exempt from registration under 4.13(a)(3), (the *de minimis* exemption); or
    - Is a non-US domiciled fund with a non-US manager and all its investors are non-US persons.
  - “Commodity Pool” and “Commodity Interests” definitions expanded to include swaps and certain FX transactions

## Verification of Eligibility and Status

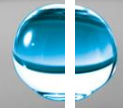


- **Swap Dealers must verify whether each counterparty is a “Special Entity” and which type of Special Entity it is:**
  - Federal agency, state, state agency, city, county, municipality, other political subdivision or any instrumentality, department, or corporation established by a State or political subdivision thereof
  - ERISA employee benefit plan
  - Government employee benefit plan
  - Endowment
  - Employee benefit plan not otherwise covered that elects to be treated as a Special Entity (e.g., foreign employee benefit plans)

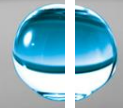


- Before recommending any swap or strategy involving a swap, a Swap Dealer must after conducting diligence have a reasonable basis to believe the swap or strategy is suitable for the counterparty for which it is recommended based on investment profile, trading objectives and ability to absorb potential losses
- Suitability Safe Harbor: Swap dealer deemed to fulfill the above obligation if:
  - Swap dealer reasonably determines the counterparty or its agent is capable of independently evaluating the swap or strategy
    - Deemed to have reasonable belief if counterparty represents that it has complied with written policies and procedures designed to ensure that the persons responsible for evaluating recommendations relating to swaps are capable of doing so
  - Counterparty or its agent represents in writing that it is exercising independent judgment in respect of the swap or strategy
  - Swap dealer discloses in writing that it is not undertaking to assess suitability
  - Additional representations required for Special Entities

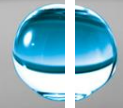




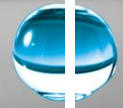
- A Swap Dealer who recommends a swap or trading strategy tailored to the needs of a Special Entity will act as an advisor to a Special Entity unless the advisor safe harbor requirements are satisfied
- Advisor Safe Harbor: Swap dealer is deemed **not to be an advisor** if:
  - ERISA Special Entity (i) ERISA SE represents in writing that it has an ERISA fiduciary responsible for representing it in connection with the swap; (ii) the identified ERISA fiduciary represents in writing that it will not rely on the SD's recommendations; and (iii) ERISA SE represents either that all recommendations concerning swaps will be evaluated by an ERISA fiduciary or that the ERISA SE has written policies and procedures reasonably designed to ensure recommendations will be evaluated by a fiduciary
  - Other Special Entity (i) SD does not express an opinion as to whether SE should enter a recommended swap or strategy; (ii) SE represents that it will not rely on SD's recommendations and will rely on advice from a "qualified independent representative" ("QIR"); (iii) SD discloses that it is not undertaking to act in the SE's best interests



- Even where the safe harbor from advisory status has been satisfied, Swap Dealer is still responsible for suitability analysis, unless, in addition to requirements for institutional investors, the Swap Dealer meets conditions of Suitability Safe Harbor
- Suitability Safe Harbor: Swap dealer is deemed to fulfill Special Entity-specific suitability obligations if they have a reasonable belief that counterparty is represented by an ERISA fiduciary (for ERISA SE) or a Qualified Independent Representative (for non-ERISA SE)
- Qualified Independent Representative
  - Sufficient knowledge to evaluate transaction
  - Not subject to statutory disqualification
  - Independent of Swap Dealer
  - Undertakes a duty to act in SE's best interest
  - Makes appropriate and timely disclosures to SE
  - Evaluates fair pricing and appropriateness of swap, consistent with SE's investment guidelines
  - For advisers to Governmental SE's, is subject to appropriate pay-to-play restrictions

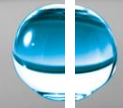


- **Clients are being asked to adhere to an industry-developed ISDA August 2012 Dodd-Frank Protocol (Protocol I), which allows them to amend their ISDA Master Agreements with multiple dealers to cover the following EBCS requirements:**
  - ECP status
  - Client classification
  - Suitability safe harbor representations
  - Consent to receive web based disclosures, optional consent to receive verbal disclosures
  - Exchange of representations / acknowledgments updating swap documentation to facilitate compliance with new Business Conduct Standards.
  
- **Protocol I consists of:**
  - Adherence letter (submitted to ISDA)
  - Questionnaire (submitted through Markit web application or e-mail)
  - Schedules of representations (elected and submitted through Questionnaire)
  - Must be signed by or on behalf of beneficial owner and any third party advisors identified (e.g., ERISA Fiduciaries or QIRs)



- **Disclosure of the following on a pre-trade basis in connection with each swap transaction:**
  - All material risks
  - All material economic terms
  - All material incentives and conflicts of interest
  - Price and Pre-Trade Mid-Market Mark
    - PTMMM No Action Relief granted for BIS-13 currencies subject to client written consent
  - Upon request, scenario analysis

## Post-Trade: CFTC Transaction Reporting



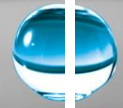
- **Swap transaction reporting rules are being implemented for market transparency and regulatory purposes**
- Part 45: FX trades will be reported to a Swap Data Repository (“SDR”) which will involve same-day and ongoing reporting of swap transaction data for regulatory purposes
- Part 43: FX trades (other than exempt FX Transactions) will be subject to real time reporting of swap transaction data for public dissemination purposes
- Swap reporting rules became effective based on asset class:
  - **December 31, 2012** for Rates and Credit swaps
  - **February 28, 2013** for Equity, FX, and Commodity swaps



## Swap Trading Relationship Documentation

- Effective July 1, 2013, swap trading documentation is required. It must define all terms governing trading and credit relationship to be in place **prior to** execution of new swaps. The rule aims to eliminate the potential risk to the market when the counterparties fail to have clear agreement on the terms governing the swap relationship. Terms to be addressed include –
  - payment obligations;
  - netting of payments;
  - events of default or other termination events;
  - calculation and netting of obligations upon termination;
  - transfer rights;
  - governing law; and
  - valuation and dispute resolution.
- Financial End Users must have documentation in place with SDs/MSPs to determine value of each swap
- End User exception election
- Portfolio Reconciliation at election of SD or MSP
- Portfolio Compression (rule already in effect) – SDs and MSPs must establish written procedures for compressions with end-users
- Swap Confirmation (rule already in effect) – SDs and MSPs obligation to send post trade confirmations ASATP but no later than end of business day and must have reasonable policies and procedures to have executed within 1 business day with financial entities and 2 business days with non-financial entity/SD/MSP

# End-User Exception from Mandatory Clearing



## ■ End-User Exception From Clearing

- Certain Interest Rate and Credit Derivative Products in first wave of Mandatory Clearing Requirement
- In addition, by electing the End-User Exception to clearing, companies are also exempt from the requirement to trade on a “Swap Execution Facility” (SEF requirement)

## ■ To qualify for the End-User Exception, the entity must:

- Not be a “Financial Entity”<sup>1</sup>
- Be using the Swap to “hedge or mitigate commercial risk”
- Notify the Swap Data Repository (“SDR”) how it “generally meets its financial obligations associated with entering into non-cleared Swaps”
- For listed companies, approval from board or relevant committee to use exemption must be obtained
- Information on how obligations are met and board approval status may be provided annually (rather than on a transaction-by-transaction basis)

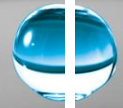
## ■ Determination of entity qualification done on an entity by entity basis

- There is a risk that certain companies or legal entities within companies may be deemed “Financial Entities”
- Companies should be working with legal counsel to confirm status
- “Financial Entities” that are a “Captive Finance Company” may still qualify for the End-User Exception<sup>2</sup>

<sup>1</sup> The definition of “Financial Entity” includes funds, pensions and entities engaged in businesses that are “financial in nature” as defined in Section 4(k) of the Bank Holding Company Act

<sup>2</sup> “Primary business” is to provide financing that facilitates the purchase or lease of products, 90% of which are manufactured by a parent or subsidiary

# Margin Requirements for FX?

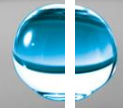


## ■ Margin Rules (As Proposed)

- CFTC and banking regulators proposed margin rules in July 2011
- Banking regulator rule would apply to Swap Dealers that are banks
  
- All proposals would require margin to be posted on uncleared swaps between financial entities
  
- CFTC proposal would not require Swap Dealers to collect margin from non-financial counterparties
  
- Banking regulator proposal would require swap dealers to collect margin from non-financial counterparties based on limits set by the Swap Dealer consistent with its internal credit risk management policies and parameters



## U.S. Person Definition & Cross Border Application



- On December 21, 2012, the CFTC issued a temporary definition of U.S. Person that expires July 12, 2013
- The December order defines a U.S. Person as any person that is:
  - i. a natural person who is a resident of the United States;
  - ii. a corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing, in each case that is (a) organized or incorporated under the laws of a state or other jurisdiction in the United States; or (b) effective as of April 1, 2013 for all such entities *other than funds or collective investment vehicles*, having its **principal place of business** in the United States;
  - iii. a pension plan for the employees, officers or principals of a legal entity described in (ii) above, unless the pension plan is primarily for foreign employees of such entity;
  - iv. an estate of a decedent who was a resident of the United States at the time of death, or a trust governed by the laws of a state or other jurisdiction in the United States if a court within the United States is able to exercise primary supervision over the administration of the trust; or
  - v. an individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in (i) through (iv) above.
- **The CFTC emphasized that this definition is temporary.**
- **It is uncertain when the CFTC might release a final definition and any other cross border rules.**