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Practice Group:

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Introduction to Clearing of Swaps and Security-Based Swaps Under Title VII of the Dodd-Frank Act

By Anthony R.G. Nolan, Lawrence B. Patent and Rachel M. Proctor

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This practice note (a) provides an introduction to the clearing requirements for swaps and security-based swaps in the United States, (b) explains how clearing works for those instruments, (c) describes the basic clearing documentation, and (d) discusses how collateral is protected in the clearing process.

Background

Before the 2008 financial crisis, the market for swaps and other over-the-counter ("OTC") derivatives transactions in the United States was characterized by bilateral arrangements in which each end-user had limited price transparency and each counterparty was exposed to the other counterparty's credit risk. If a counterparty defaulted under the contract, the non-defaulting counterparty's ability to perform on unrelated transactions, and ultimately its solvency, could be affected. The prevalence of bilateral arrangements made the OTC swaps market more susceptible to counterparty default. Following the 2008 financial crisis, the opacity of the bilateral swaps market and the potential for a default by a large swap counterparty to threaten the solvency of its counterparties were viewed as threats to financial stability.

Accordingly, regulators and some market participants believed that mandating central clearing would reduce systemic risk in the OTC derivatives markets because it would promote standardization of certain swaps and transparency, and reduce a market participant's risk with regards to counterparty creditworthiness. However, some market participants and industry observers expressed concern that such a clearing mandate would concentrate risk within the central clearing houses. Although the risk of default by a central clearing house is small given that it is organized to be balanced between buyers and sellers within the market, if a central clearing house were to default, the consequences would be far-reaching and potentially catastrophic for various counterparties.

Despite some misgivings that central clearing houses could pose dangers of financial instability owing to their size and ubiquity, Congress adopted the clearing mandate and it became a cornerstone of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") that standardized swaps be centrally cleared.

Clearing Before the Dodd-Frank Act

Prior to the Dodd-Frank Act, an end-user looking to enter into a swap had to approach swap dealers privately to learn the pricing terms they were willing to offer. Once commercial terms were agreed upon with a given dealer, the parties would typically enter into the swap by

executing a bilateral agreement off-exchange pursuant to the terms of an International Swaps and Derivatives Association

Master Agreement ("ISDA Master") and possibly a credit support annex ("CSA"). For more information about ISDA documentation, see "A Practical Guide to the ISDA Master Agreement." The parties would make payments to each other directly.

The Dodd-Frank Act's Clearing Requirements

Title VII of the Dodd-Frank Act amended Section (2)(h) of the Commodity Exchange Act ("CEA") to make it generally unlawful for any person to engage in a swap that is required to be cleared unless that person submits such swap for clearing to a derivatives clearing organization ("DCO"). 7 U.S.C. § 2(h)(1)(A). The Commodity Futures Trading Commission ("CFTC") was given authority to determine whether a swap is required to be cleared, and the Securities Exchange Commission ("SEC") was given similar authority over security-based swaps. For an explanation of the difference between swaps and security-based swaps, see "Introduction to the United States Regulation of Swaps and Security-Based Swaps Under Title VII of the Dodd-Frank Act."

Swap Clearing Requirements

Section 723 of the Dodd-Frank Act authorizes the CFTC to establish clearing requirements for swaps and security-based swaps. 7 U.S.C. § 2(h)(2). It also prohibits any person from entering into a swap that is required to be cleared unless (a) that person submits that swap for clearing through a DCO or (b) an exception from the clearing requirement exists (e.g., the commercial end-user exception).). For an explanation of the commercial end-user exception, see "Introduction to the Commercial End-User Exception to Mandatory Clearing of Swaps and Security-Based Swaps Under Title VII of the Dodd-Frank Act." As a corollary to the clearing requirement, a cleared swap or security-based must be executed on a designated contract market (a "DCM") or a swap or security-based swap execution facility (a "SEF"). 7 U.S.C. § 2(h)(8). A DCM is a board of trade (or exchange) that operates under the regulatory oversight of the CFTC, pursuant to Section 5 of the CEA. A SEF is a trading system or platform in which multiple participants have the ability to execute or trade swaps (or security-based swaps) by accepting bids and offers made by multiple participants in the facility or system.

The CEA requires the CFTC to review swaps, or any group, category, type, or class of swaps, on an ongoing basis, to make a determination as to whether the swap, category, type, or class of swaps should be required to be cleared. 7 U.S.C. § 2(h)(2)(A)(i). In the event the CFTC issues a clearing requirement determination, the CFTC's regulations establish time frames for when parties will be required to submit swaps for clearing. 77 Fed. Reg. 44441 (July 30, 2012). The compliance schedule is as follows:

Type of Entity	Time Frame for Mandatory Clearing
Swaps where both parties are **Category 1 Entities** (*i.e.,* swap dealer, major swap participant and certain active funds executing more than 200 swaps per month)	90 days after the final rule is published

Swaps where one party is a **Category 1 Entity** or a **Category 2 Entity** (commodity pools, private funds, or persons predominantly engaged in activities that are financial in nature) and the other party is a **Category 2 Entity**	180 days after the final rule is published
Swaps between **other parties** (*e.g.,* transactions between Category 1 entities and third-party subaccounts or nonfinancial end-users)	270 days after the final rule is published

CFTC Extant Clearing Determinations

On November 28, 2012, the CFTC issued the first, and, as of January 15, 2016, only clearing determination, which applies to certain interest rate swaps and untranched broad-based index credit default swaps. See 77 Fed. Reg. 74284 (Dec. 13, 2012). The interest rate swaps at issue involve four types (fixed-to-floating, basis, forward rate agreement and overnight index) and four currencies (U.S. dollar, Euro, British pound and Japanese yen). 17 C.F.R. § 50.4(a). The credit default swaps at issue involve untranched broad-based index credit default swaps that clear on Markit's North American and European corporate indices, covering various tenors and series. See CFTC Regulation § 50.4(b), 17 C.F.R. § 50.4(b).

It is expected that any future clearing mandates would cover swaps that have the most standardized terms and the greatest liquidity. For example, the CFTC's Global Markets Advisory Committee has discussed clearing mandates for certain non-deliverable currency forwards. However, the International Monetary Fund assumes that one-quarter of interest rate swaps, one-third of credit default swaps, and two-thirds of other swaps will not be sufficiently standardized and liquid to be centrally cleared.

Security-Based Swap Clearing Requirements

The Dodd-Frank Act also amended the Securities Exchange Act of 1934, as amended (the "Exchange Act") to provide that if a security-based swap is required to be cleared, it shall be generally unlawful for any person to engage in a security-based swap unless that person submits such security-based swap for clearing to a DCO. 15 U.S.C. 78c-3(a)(1). Section 3C(b) of the Exchange Act also requires the SEC to review security-based swaps (or groups, categories, types, or classes thereof) and determine whether such security-based swaps should be cleared.

To date, the SEC has not issued any clearing determinations for security-based swaps.

The Essentials of Clearing

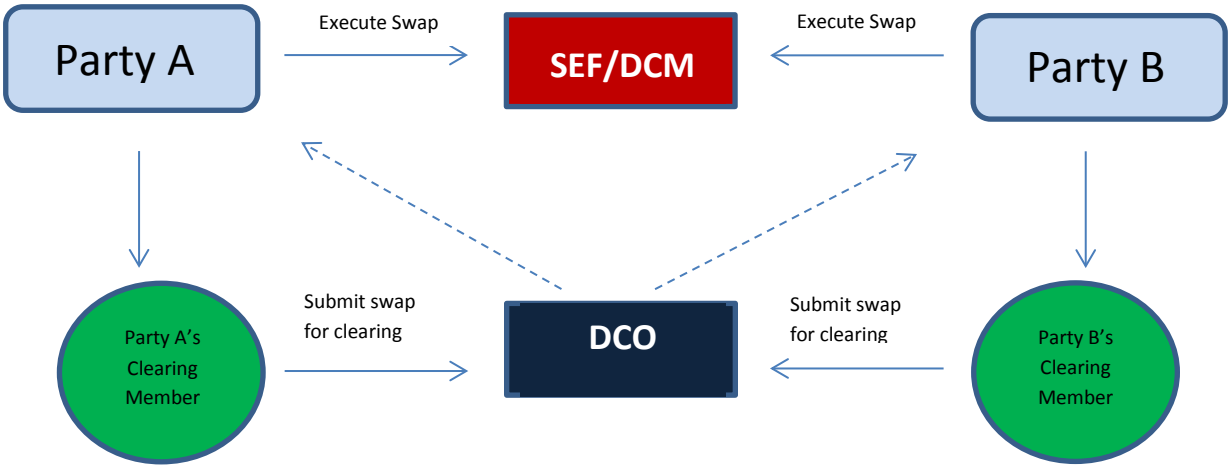
For those swaps that are required to be cleared, the bilateral negotiation and execution process has been replaced by a process pursuant to which the swap is executed on a SEF or DCM, and later cleared on a DCO through a clearing member (as defined below). This process generally entails the following steps:

1. Pricing to Execution. End-users looking to enter into centrally cleared swaps may become participants of a SEF or DCM. These multilateral platforms make pricing offered

by swap dealers available to be viewed by all participants. While the parties must still put in place an ISDA Master and CSA to govern the transaction, they will execute the trade using the facilities of the SEF or DCM, as applicable.

2. Submit the Swap for Clearing. Once the agreement has been executed, the swap will be submitted to the DCO for clearing. A DCO has members ("Clearing Members") who submit derivative transactions (e.g., swaps) for clearing through the DCO and who are subject to the DCO rules. Clearing Members may submit for clearing transactions made on their own behalf or on behalf of customers. Clearing Members that submit swaps entered into by customers for clearing must be registered as futures commission merchants ("FCMs"). Typically, end-users will arrange for an FCM that is a Clearing Member to submit swaps for clearing on their behalf.

3. DCO Accepts Swap for Clearing; DCO Enters into Contracts with Each Counterparty. After the DCO has accepted the swap for clearing, the DCO steps in between the two parties. The DCO now directly faces each of the parties under two separate swap transactions; the parties no longer face each other. Further, each swap transaction is no longer governed by the agreement executed between the parties (i.e., the ISDA Master and CSA); instead, each swap between the DCO and each party is governed by the DCO's rules. The DCO assumes the counterparty credit risk of each of the original counterparties; now, neither counterparty is exposed to the credit risk of the other (i.e., if one party defaults under their contract with the DCO, the DCO will still perform under its separate contract with the other party).



Documentation needed to clear swaps and security-based swaps

SEF/DCM Trading Membership or Participation Agreement

If a swap is required to be centrally cleared, it must be executed on a SEF or DCM. Thus, if a party desires to enter into a centrally cleared swap, it must have the proper documentation

in place with a SEF or DCM that has made such swap available for trading. (The parties may also decide voluntarily to submit OTC swaps for clearing.)

Each SEF/DCM will have its own form of agreement, but it will generally be in the form of a trading membership agreement or a participation agreement. This agreement is not typically negotiated. A list of SEFs can be found here. A list of DCMs can be found here.

Cleared Derivatives Addendum

As mentioned above, a party must be a member of a DCO in order to submit a swap for clearing through a DCO. Otherwise, it must use the services of a Clearing Member of the DCO. Such Clearing Member will submit the transaction for clearing on behalf of its customer. Clearing Members must be registered as FCMs. Most end-users are not members of DCOs and, therefore, must retain an FCM to perform this function on their behalf.

The Futures Industry Association ("FIA") and ISDA published a template addendum for U.S.-registered FCMs and their customers to use to document their relationship with respect to clearing OTC derivatives. The Cleared Derivatives Addendum is designed to supplement a futures and options agreement between the FCM and its customer, and includes representations regarding clearing-related matters and provisions addressing closeout procedures for cleared swaps, terminated trades, and liquidation. The template is customizable by the parties. Commonly negotiated terms include margin requirements, a party's ability to change position limits, the Clearing Member's responsibility for transactions rejected from clearing, a party's ability to transfer cleared trades to other clearing members and terms specific to different categories of swap transactions (i.e., rate swaps versus credit default swaps). A copy of the FIA/ISDA Cleared Derivatives Addendum can be found here.

Customer Account Agreement

In addition to the Cleared Derivatives Addendum, parties will need to enter into a Customer Account Agreement or other such agreement with the FCM acting as their Clearing Member. Customer Account Agreements will vary from FCM to FCM. Particularly noteworthy provisions include collateral posting obligations, protection of customer assets, liquidation of collateral following a default, and reporting obligations. Commonly negotiated terms include scope of events of default and remedy provisions, scope of lien grants, including which obligations are secured and which collateral is securing it, the ability to transfer collateral to other parties without consent, the ability to dispute erroneous reporting and amendment provisions. Parties should also review the rules of the particular DCO where the swap will be cleared and the particular SEF or DCM where it will be executed.

Collateral Segregation and Customer Protection

Counterparties to cleared swaps are typically required by DCOs to post collateral to secure their obligations under such swaps. Because end-users who are customers of FCM Clearing Members use the services of such Clearing Member to face the DCO, such customers provide collateral to their FCM Clearing Member, and the FCM Clearing Member, in turn, provides collateral to the DCO. The protection of the funds that customers deposit with their FCMs and with DCOs as collateral is a crucial issue for the stability of a clearing system, as

customers are potentially subject to the bankruptcy risk of the FCM, the DCO, and fellow customers of a DCO or FCM.

Collateral Protection of Swaps

Pursuant to the Dodd-Frank Act, the CFTC adopted a regime for the protection of customer funds deposited as collateral for trading in cleared swaps. Although a customer protection regime has been in place for many decades for exchange-traded futures, the corresponding regime for OTC derivatives is distinct from that regime and differs from it in several respects.

Section 724 of the Dodd-Frank Act prescribes the manner in which cleared swaps (and related collateral) must be treated prior to and after bankruptcy. Section 724(a) of the Dodd-Frank Act amends the CEA by creating a new section 4d(f), which requires each FCM and DCO to (a) hold cleared swaps customer collateral in an account (or location) that is separate from the property belonging to the FCM or DCO, and (b) not use the collateral of one cleared swaps customer to cover (i) the obligations of another cleared swaps customer or (ii) the obligations of the FCM.

The CFTC considered several alternative means to protect the collateral posted by FCM customers for cleared swap positions, ranging from a system essentially identical to that for futures, to a regime of full physical segregation. Ultimately, the CFTC adopted a rule that requires legal segregation of collateral with operational commingling (commonly known as "LSOC") of the collateral posted by parties for cleared swaps. The LSOC rules provide that the FCM and DCO must treat the collateral as customer property, and mandate how the collateral must be handled. 17 C.F.R. § 22.2(a).

Collateral Segregation for Cleared Swap Margin

Under the LSOC rules, the FCM and DCO may not commingle cleared swaps collateral with (i) their own assets, or (ii) assets of a non-cleared swap customer. 17 C.F.R. § 22.2(c)(2). However, all cleared swaps collateral may be commingled in an omnibus account with assets of other cleared swaps customers. 17 C.F.R. § 22.2(c)(1). Despite the ability to commingle, the FCM and DCO are required to maintain detailed records setting forth how much collateral was provided by each customer. 17 C.F.R. § 22.2(b)(2). The FCM must make daily reports to the DCO regarding customer collateral. 17 C.F.R. § 22.11(c).

Treatment of Cleared Swap Collateral

The FCM and DCO are allowed to reinvest the collateral posted by the customer, but there are limits to the reinvestment. The FCM is not permitted to: (a) grant liens on cleared swaps collateral in the omnibus account; (b) use cleared swaps collateral of one cleared swaps customer to purchase, margin, or settle transactions of another person; or (c) use cleared swaps collateral of a customer to secure obligations of that customer under transactions that are not cleared swaps. 17 C.F.R. § 22.2(d).

Protection of Cleared Swap Collateral

The LSOC model is designed to protect customer assets in the event of both a "single default scenario" and "a double default scenario." In the event a fellow customer of the FCM defaults (a single default scenario), the FCM cannot use a non-defaulting cleared swap

customer's collateral to cover the obligations of the defaulting-customer. There is no "fellow customer risk." 17 C.F.R. § 22.15.

In a double default scenario, the default of another cleared swaps customer of the FCM causes the FCM to also default on its obligations to the DCO. In the event of a double default, the LSOC model provides that the DCO cannot use a non-defaulting cleared swap customer's collateral to cover the default of another customer. If the FCM itself is bankrupt or insolvent, the LSOC further protects the non-defaulting customer's collateral by creating a process by which the non-defaulting customer's cleared swaps positions (including the related collateral) are transferred to another solvent FCM. 77 Fed. Reg. 63369.

Bankruptcy Code Treatment of Swap Collateral

In addition to the protections described above, the Dodd-Frank Act also clarified that cleared swaps are "commodity contracts" within the meaning of Section 761(4)(F) of the Bankruptcy Code. Accordingly, in the event a FCM or DCO files for bankruptcy or insolvency, the contractual right of an FCM or certain other categories of person to cause the liquidation, termination, or acceleration of the commodity contract (or a master netting agreement consisting of one or more commodity contracts) or to exercise a right of setoff with respect thereto is excluded from the automatic stay under the Bankruptcy Code.

Collateral Protection of Security-based Swaps

Section 763 of the Dodd-Frank Act prescribes the manner in which cleared security-based swaps (and related collateral) must be treated prior to and after bankruptcy. Section 763(e) of the Dodd-Frank Act amends the Exchange Act by creating a new section 3E, which requires each broker, dealer, or security-based swap dealer and DCO to (a) treat and deal with all money, securities, and property of any security-based swaps customer received to margin, guarantee, or secure a security-based swap cleared by or though a clearing agency (including money, securities, or property accruing to the security-based swaps customer as the result of such a security-based swap) as belonging to the security-based swaps customer; and (b) separately account for such property and not commingled, such assets with the funds of the broker, dealer, or security-based swap dealer or be used to margin, secure, or guarantee any trades or contracts of any security-based swaps customer or person other than the person for whom the same are held. . 78 U.S.C. § 78c-5. The SEC has not promulgated rules for protection of collateral for cleared security-based swaps, but it is expected that rules will be similar to the customer protection rules that generally apply in stockbroker liquidations and in proceedings under the Securities Investor Protection Act.

Bankruptcy Code Treatment of Security-based Swap Collateral

The Dodd-Frank Act clarifies that a security-based swap is considered to be a security for purposes of the Bankruptcy Code, and that an account that holds a security-based swap, other than a portfolio margining account, is considered to be a securities account (as that term is defined in Section 741 of the Bankruptcy Code).

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Authors:

Anthony R.G. Nolan
anthony.nolan@klgates.com
+1 212 536 4843

Lawrence B. Patent
lawrence.patent@klgates.com
+1 202 778 9219

Rachel M. Proctor
rachel.proctor@klgates.com
+1 503 226 5787

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