



## DODD-FRANK ESSENTIALS FOR END USERS OF OTC DERIVATIVES - UPDATE 6

### Are Your Contracts Ready for OTC Clearing and Collateral Segregation?

Many readers may already be familiar with the provisions in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) that provide for mandatory clearing of certain OTC derivatives transactions<sup>1</sup> and for segregation of client collateral for uncleared OTC derivatives.<sup>2</sup> While the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) have recently announced delays in the promulgation of final rules under Title VII,<sup>3</sup> it is apparent that many commonly traded types of swaps will, sooner or later, be subject to either the clearing or the collateral segregation requirements. Given the complexity of these arrangements, it is not too soon to think seriously about the contracts that will be necessary to accommodate these requirements.

### Dodd-Frank’s Segregation Requirement for Uncleared Swaps

Title VII of Dodd-Frank requires that a swap dealer or major swap participant (both of which will be CFTC- or SEC-registered entities) entering into an uncleared swap transaction notify its unregistered counterparty of the counterparty’s right to require the segregation of collateral posted as initial margin or “independent amount” under such swap transaction with an independent third party custodian.<sup>4</sup>

<sup>1</sup> This topic has been addressed in our previous Investment Products update, “Preparing for OTC Derivatives Clearing” (*available at* <http://www.sidley.com/sidleyupdates/Detail.aspx?news=4762>).

<sup>2</sup> For further background on the Dodd-Frank segregation requirements, please refer to our previous Dodd-Frank End Users update “Segregation of Client Collateral for Uncleared Derivatives under Dodd-Frank” (*available at* <http://www.sidley.com/sidleyupdates/Detail.aspx?news=4601>).

<sup>3</sup> The CFTC’s most recent announcement regarding implementation of rules under Title VII is explained in our September 14, 2011 Derivatives update (*available at* <http://www.sidley.com/sidleyupdates/Detail.aspx?news=4945>). The delayed implementation of rules under Title VII by the CFTC and the SEC was addressed in our Derivatives update of June 20, 2011 (*available at* <http://www.sidley.com/sidleyupdates/Detail.aspx?news=4855>).

<sup>4</sup> The segregation (and associated notification) requirement for collateral posted in respect of swaps is set out in section 724(c) of Dodd-Frank. The analogous requirement for security-based swaps is contained in clause (f) under Dodd-Frank section 763(d). It should be emphasized that the segregation requirement does not apply at all to any variation margin provided under such swaps. *See* clause (l)(2)(B)(i) under Dodd-Frank section 724(c), and clause (f)(2)(B)(i) under Dodd-Frank section 763(d).

The documentation required to create a “tri-party” segregation arrangement for custody of independent amount typically includes a custody and control agreement (provided by the custodian), and a form of credit support document (typically in the form of an amendment to the Credit Support Annex) that provides for the transfer of the initial margin to the third-party custodian separately from the transfer terms applicable to variation margin. Some of the issues that end users will want to focus on in negotiating these include (i) the circumstances under which the secured party and/or custodian may exercise remedies against the segregated collateral; (ii) the circumstances that will enable a pledgor to ask for return of collateral (these can range from the naming of an early termination date to insolvency of the secured party); (iii) whether the end user/pledgor must give prior notice to the secured party or wait for some period of time before instructing the custodian to return assets following default of the secured party; (iv) whether and under what terms collateral may be substituted; (v) the standard of care the custodian must use in holding collateral; and (vi) which party bears the risk of loss if the custodian becomes insolvent.

## OTC Clearing Is Coming: Have You Spoken to Your FCM Lately?

A growing number of clearing platforms are being established in response to the mandatory clearing requirement, with sponsors hoping to capture a piece of the captive market for OTC derivatives clearing.<sup>5</sup> Following enactment of Dodd-Frank in 2010, it seemed at first as if two types of clearing models would be available: one based on the currently ubiquitous ISDA® Master Agreement, and the other based on a futures clearing approach. However, it has become clear over the last nine months that most of the clearing platforms are going to use the futures clearing model. Clearinghouses that use the futures clearing model will require that each end-user enter into a futures customer agreement with a futures commission merchant (FCM), with an addendum to deal with OTC derivatives.<sup>6</sup>

The futures customer agreement will become a key trading agreement for end users of OTC derivatives, given that it will likely govern a substantial portion of the end-user’s OTC derivatives portfolio. End-users that have an existing customer agreement with an FCM may want to review that agreement in light of the increased importance this arrangement will have. End-users that do not currently have a customer agreement with an FCM should consider beginning their search for appropriate FCM relationships. The typical FCM customer agreement favors the interests of the FCM, and may not adequately take into account certain features that distinguish cleared OTC swaps from futures contracts.<sup>7</sup> Careful review and negotiation of the FCM customer agreement<sup>8</sup> is therefore advisable, and existing FCM customer agreements may warrant re-negotiation. This will likely take some time, and end-users that have to enter into an FCM customer agreement in short order so as to comply with mandatory clearing requirements may face pressure to accede to unfavorable terms in order to execute documentation in time to allow for continuity of business.

## Next Steps

With respect to tri-party segregation arrangements, end-users should consider whether to request segregation for their initial margin and, if so, which custodians are available. It is possible that swap dealers and major swap participants will have arrangements in place with a particular custodian and not others, so that the available choices might be limited. In addition, the terms of the tri-party segregation arrangement will need to be carefully considered and negotiated in order

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<sup>5</sup> These clearinghouses include CME, ICE, LCH, IDCH and NYSE Euronext.

<sup>6</sup> Security-based swaps regulated by the SEC, such as single-name CDS, will also likely clear using a futures model: many FCMs are also registered broker-dealers, so in many cases the same entity will be a clearing member for both a clearinghouse handling CFTC-regulated swaps and a clearinghouse handling SEC-regulated security-based swaps. For purposes of this update, when referring to an FCM we also mean to refer to a broker-dealer that is a clearing member with respect to a clearinghouse that handles security-based swaps regulated by the SEC.

<sup>7</sup> The OTC addendum is intended to address some of the features that distinguish an OTC swap from a futures contract, but as of this writing it is not clear whether the addendum provides sufficient comfort to end users accustomed to trading OTC derivatives on a bilateral basis.

<sup>8</sup> Insofar as trading of cleared OTC derivatives is concerned, the Futures Industry Association and ISDA published on June 16, 2011 a form of “Cleared Derivatives Execution Agreement” that is available for use.

to achieve the best result, both from a legal and operational standpoint. Custodians may be reluctant to agree to significant changes to their form of custody agreement, so sufficient time should be allocated to ensure the documents can be properly reviewed and any desired changes discussed. Because of the material differences between the most widely used custodial agreements, we also recommend that you meet with prospective custodians and ask them to explain their segregation and custodial arrangements as compared to others.

With respect to clearing of OTC derivatives using the futures clearing model, end-users will need to conduct a thorough legal and contractual risk analysis of their current or prospective futures customer agreement(s) with their legal counsel in order to be able to make their own overall risk analysis and to prevent disruption in trading activity by executing necessary documentation on a timely basis. As part of this process, end-users will need to consider whether they should maintain multiple clearinghouse relationships (to diversify or spread their settlement risk across available central counterparties) and whether they should maintain multiple clearing member (*i.e.*, FCM) relationships (to mitigate credit risk as well as to ensure full access to the relevant traded products).

Previous updates in this series are available at [www.sidley.com](http://www.sidley.com):

- [Update 1: What Is a “Swap”?](#)
- [Update 2: Inter-Agency Request for Comments on “Key Definitions” of Title VII](#)
- [Update 3: CPO/CTA Registration Requirements under Dodd-Frank](#)
- [Update 4: What Is a “Major Swap Participant”?](#)
- [Update 5: Segregation of Client Collateral for Uncleared Derivatives under Title VII of Dodd-Frank](#)

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