



Joint Meeting of the EFMLG/FLB/FMLC/FMLG

Business Conduct Standards
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Swaps Regulation – the Wall Street Transparency and Accountability Act – Title VII

- The Dodd-Frank Wall Street Reform and Consumer Protection Act brings comprehensive reform to the regulation of swaps. The Dodd-Frank bill authorizes the Commodity Futures Trading Commission (CFTC) to:
- **Regulate Swap Dealers**
 - Swap dealers will be subject to capital and margin requirements to lower risk in the system.
 - Dealers will be required to meet robust business conduct standards to lower risk and promote market integrity.
 - Dealers will be required to meet recordkeeping and reporting requirements so that regulators can police the markets.
- **Increase Transparency and Improve Pricing in The Derivatives Marketplace**
 - Instead of trading out of sight of the public, standardized derivatives will be required to be traded on regulated exchanges or swap execution facilities.
 - Transparent trading of swaps will increase competition and bring better pricing to the marketplace. This will lower costs for businesses and their consumers.
- **Lower Risk to the American Public**
 - Standardized derivatives will be moved into central clearinghouses to lower risk in the financial system.
 - Clearinghouses act as middlemen between two parties to a transaction and take on the risk that one counterparty defaults on their obligations.
 - Clearinghouses have lowered risk in the futures marketplace since the 1890s. The Dodd-Frank bill will bring this crucial market innovation to the swaps marketplace.

Business Conduct Standards Overview

Business Conduct Standards Rules

- Applies whether or not FX forwards, options, swaps are exempted
- Applies to all customers *except* spot/payment only customers
- Requires customer due diligence, including
 - Know Your Customer information
 - Suitability analysis
 - Verification of ECP status
 - Identification of Special Entities (requires additional duty to Special Entities)
- Requires new, detailed disclosures for all FX products except spot. Such disclosures must include:
 - Material risks (market, credit, liquidity, foreign currency, legal , operational and any other applicable risks)
 - Specific characteristics
 - Incentives
 - Conflicts
- Requires daily marks to be provided or available to counterparty

OCC Proposed Rules (for US banks)

- Applies to “retail forex” = FX [futures and options] with non-ECP customers
- Requires “supervisory non-objection” from the OCC
- Requires automatic payment netting
- Requires new Risk Disclosure documentation, including WFB profitable accounts ratios, fees and other charges
- Specifies recordkeeping requirements
- Requires margin for every retail forex customer
 - 2% of notional for major currency pairs and 5% of notional for all others (the “Standard Margin”)
 - For short options, the Standard Margin plus the premium received by the retail forex customer
 - For long options, the Standard Margin plus the full premium charged and received by WFB

Swap Dealers are required to adhere business conduct rules as specified in the Act and as may be prescribed by CFTC rules that relate to:

- fraud, manipulation, and other abusive practices (including swaps that are offered but not entered into);
- diligent supervision of the business of the Swap Dealer;
- adherence to position limits; and
- such other matters as the CFTC determines to be appropriate.

CFTC Rules Regarding Business Conduct Standards

Business conduct requirements adopted by the CFTC shall:

- Establish duty for Swap Dealer to verify that a Counterparty meets the eligibility requirements for ECP status;
- Require disclosure by the Swap Dealer to Counterparty of:
 - material risks and characteristics of the swap;
 - any material incentives or conflicts of interest that the Swap Dealer may have in connection with the swap;
 - for cleared swaps, upon request of the Counterparty, receipt of the daily mark of the transaction from the appropriate DCO; and for uncleared swaps, receipt of the daily mark of the transaction from the Swap Dealer.
- Establish a duty for a Swap Dealer to communicate in a fair and balanced manner based on principles of fair dealing and good faith;
- Establish such other standards and requirements as the CFTC may determine are appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

Eligible Contract Participants –

Eligible Contract Participant (ECP) —definition not extensively changed but there are some notable differences including “discretionary investments”

- It is illegal to do swaps OTC with counterparties that are not ECPs;
- Proposed exemption of “foreign exchange forwards” and “foreign exchange swaps” published by Treasury on 4/29/11;
- Exempt products still need to adhere to Business Conduct Standards;
- Open Question. Since ECP definition is within the Business Conduct Standards, must exempt products still need to be with ECPs and the exemption only applies to clearing requirements?
- Notation. Retail (non-ECP) Forex Rules issued by Office of Comptroller of Currency.

Eligible Contract Participants and the Duty to Verify

- Swap Dealer must verify ECP status “before offering or entering into a swap”;
- Shall also verify at such time whether Counterparty is a Special Entity (see below);
- May rely on reasonably based representations, which may be “contained in a master or written agreement”;
- Example: Representation that the Counterparty is an ECP can be done in ISDA Schedule or other Master Agreement but this may be too late;
- Does not apply to swaps initiated on an SEF or where the Swap Dealer does not know the identity of the counterparty;
- Open Question – does this duty to verify apply to exempt FX products? Must this duty only take place if the Counterparty is entering into a option, NDF, or cross-currency swap?

How good are your disclosures?

The Act Requires disclosure of:

- Material risks and characteristics of swap;
- Any material incentives or conflicts of interest;
- Right to receive daily MTM from the appropriate DCO for cleared swaps;
- Right to receive daily MTM directly from the Swap Dealer for uncleared swaps

The CFTC Proposed Rule contains more detail and requires disclosures “At a reasonably sufficient time prior to entering into a swap” (note absence of “offering”) must notify of:

- material risks (market, credit, liquidity, fx, legal, operational, “and any other applicable risks”)
 - CP can request scenario analysis
 - for high-risk complex swaps (degree of leverage, potential for reduced liquidity, lack of price transparency), Swap Dealer “shall” provide scenario analysis;
- Material characteristics – which include economic terms of the swap, terms relating to the operation of the swap, and rights and obligations of the parties during the term of the swap;
- Material incentives and conflicts of interest include the price of the swap and the “mid-market value” and any compensation or other incentive from any source other than Counterparty;

Price Transparency is the New World Order

- Cleared swaps—must disclose right to get daily mark from DCO
- Uncleared swaps—must disclose:
 - daily mark at “the mid-market value”
 - methodology and assumptions for daily mark
 - that mark may not be replacement price
 - that calls for margin may be based on considerations other than the mark
 - that mark may not necessarily be value of the swap that is on the Swap Dealer books
- For swaps required to be cleared, Swap Dealer shall notify Counterparty of right to select DCO
- For swaps not required to be cleared, shall notify that Counterparty:
 - May elect to require clearing of the swap
 - Shall have the sole right to select DCO

Special Entities – the end of trading with retirement plans?

Under the Act

- Include governments, municipalities, pension plans, endowments
- Need to document the fact that the entity is represented by an independent sophisticated investment manager
- Special duties if an “advisor”

Under the Rule

- Swap Dealer must have a reasonable basis to believe that Special Entity has a representative that:
 - Has sufficient knowledge to evaluate transaction and risks
 - Is not subject to a statutory disqualification
 - Is independent of the Swap Dealer
 - Undertakes a duty to act in the best interests of the SE
 - Evaluates fair pricing and appropriateness
 - If ERISA plan, is a fiduciary
 - If a municipality as defined in §23.451 is subject to restrictions on political contributions
- Criteria for independence
- Criteria for reasonable reliance

Documentation Standards – What are we doing today?

- Must adopt written policies and procedures
- Swap trading relationship must be in writing and include all terms governing its trading relationship (incl. payment obligations, netting, events of default/ATEs, termination rights, transfer, governing law, valuation, dispute resolution)
- Confirmations are “included”
- Credit support is included (initial and variation margin requirements, eligible assets and haircuts, investment and rehypothecation terms, custodial arrangements, including whether segregation is required)
- Must have written documentation on procedures for valuations
- Cleared swaps must record date and time swap accepted for clearing, name of DCO, name of clearing members for each party, statement that original swap is extinguished and replaced, terms conform to “templates” established under DCOs rules, and terms of swap on books of clearing member conform to terms of the cleared swap established under DCOs rules
- Must have an audit once a year examining no less than 5% of the documentation created during the previous year to ensure compliance
- Must report valuation disputes not resolved within one business day (SDs) or five business days (others)
- Need to obtain documentation sufficient as a basis for end-user exception from mandatory clearing

The End-User Exemption

- Swap Dealer shall obtain documentation sufficient to provide a reasonable basis on which to believe that Counterparty is entitled to the exception

- Such documentation includes:
 - Identity of Counterparty
 - That Counterparty has elected not to clear the swap
 - Counterparty is a “non-financial entity” (i.e. is other than an Swap Dealer, a commodity pool, a private fund, an ERISA plan, etc)
 - Counterparty is hedging or mitigating a commercial risk
 - Counterparty generally meets its financial obligations associated with non-cleared swaps