

Alert

ISDA to Publish Second Addendum to the August 2012 Protocol

February 28, 2013

The International Swaps and Derivatives Association published the second addendum (the "Addendum") to the ISDA August 2012 Protocol Questionnaire (the "August Protocol") on February 22. It will be available for completion electronically on Markit's ISDA Amend on April 1. This *Alert* summarizes the content of the Addendum, which includes a fund's (i) option to waive the right to receive disclosure of pre-trade, mid-market marks, (ii) self-identification as a U.S. person or non-U.S. person, and (iii) self-identification as a "category 2 entity," if applicable, for purposes of the upcoming June and July clearing deadlines. Completion of the Addendum is optional and will not affect the August Protocol. In addition, funds are not required to answer all questions, but may choose to answer one or more questions.

Background

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the Commodity Futures Trading Commission ("CFTC") issued a number of business conduct rules that require swap dealers to obtain information from their swap counterparties and to provide disclosure to their swap counterparties, which include funds. The August Protocol is an industry document that provides a means for funds to incorporate provisions into their swap documentation to enable the swap dealers to satisfy such CFTC rules.

The Addendum includes content related to the following three topics:

1. Disclosure of Pre-Trade Mid-Market Marks for Certain Transactions

Swap dealers, according to CFTC regulations, must provide private funds "material information concerning the swap in a manner reasonably designed to allow the counterparty to assess ... [such swap dealer's] material incentives and conflicts of interest" which includes "disclosure of the ... price of the swap and the mid-market mark of the swap."¹

Industry participants requested that swap dealers not have to provide mid-market information with respect to certain derivatives because such derivatives are highly liquid, exhibit narrow bid-ask spreads and are highly quoted by swap dealers.

In December, the CFTC issued no-action relief, stating that, with respect to such specified derivatives, no mid-market mark needs to be disclosed provided that consent is obtained from counterparties.² Therefore, the

¹ CFTC Regulation 23.431(a)(3).

² In particular, pursuant to CFTC No-Action Letter 12-42 and CFTC No-Action Letter 12-58, the letters set forth the following derivatives: (i) an untranching credit default swap referencing the on-the-run and most recent off-the-run series of the following indices: CDX.NA.IG 5Y, CDX.NA.HY 5Y, iTraxx Europe 5Y and iTraxx Europe Crossover 5yr; and (ii) an interest rate swap (A) in the "fixed-for-floating swap class" (as such term is used in CFTC Regulation 50.4(a)) denominated in USD or EUR, (B) for which the remaining term to the scheduled termination date is no more than 30 years, and (C) that has specifications set out in CFTC Regulation 50.4, in each case where a real-time executable bid and offer price is available. In addition, the following additional products are covered: (i) a "foreign exchange forward" or "foreign exchange swap," as defined in Sections 1a(24) and 1a(25) of the Commodity Exchange Act, respectively, that, by its

Addendum provides funds the right to “opt out” of such disclosure with respect to the specified foreign exchange and derivative transactions, as well as for future transactions for which the CFTC might issue additional no-action or other relief.

2. U.S. Person Representation

On Dec. 21, 2012, the CFTC published a final order which, among other things, adopted a temporary definition of “U.S. person” for swap dealers to use in order to determine compliance with their status as a “swap dealer.” The Addendum requires parties to specify whether or not they meet this definition of “U.S. person.” This will enable swap dealers to calculate whether they satisfy the requisite threshold requiring such swap dealers to register with the CFTC and whether or not business conduct standards apply to certain transactions.

3. Clearing

Funds and other entities that are “category 2” entities will commence clearing certain specified swaps on June 10, 2013 and other specified swaps on July 25, 2013.³ The Addendum, in order to allow swap dealers to coordinate compliance with the relevant clearing date, requests that counterparties specify whether they are a category 2 entity.

Below is a summary of the mandatory clearing dates and definitions of the different categories of entities. Also below is a list of the swaps that will be subject to mandatory clearing.

| | Definition | Clearing Deadline |
|--------------------------|--|--|
| Category 1 Entity | Swap dealers and “active funds” (which are private funds that executed a monthly average of 200 or more swaps per month over the 12-month period preceding such mandatory clearing determination) | <ul style="list-style-type: none"> ▪ March 11, 2013 for all swaps listed below other than iTraxx ▪ April 26, 2013 for iTraxx |
| Category 2 Entity | Private funds that are neither “active funds” nor accounts managed by third-party investment managers (discussed below), commodity pools and other entities that engage in activities that are financial in nature | <ul style="list-style-type: none"> ▪ June 10, 2013 for all swaps listed below other than iTraxx ▪ July 25, 2013 for iTraxx |
| Category 3 Entity | Accounts managed by third-party investment managers ⁴ as well as ERISA pension plans | <ul style="list-style-type: none"> ▪ Sept. 9, 2013 for all swaps listed below other than iTraxx ▪ Oct. 23, 2013 for iTraxx |

terms, is physically settled, where each currency is one included among the BIS 13 Currencies, and where the transaction has a stated maturity of one year or less, or (ii) a vanilla foreign exchange option that, by its terms, is physically settled, where each currency is one included among the BIS 13 Currencies, and where the option has a stated maturity of six months or less, in each case where a real-time executable bid and offer price is available.

³ On Dec. 13, 2012, the CFTC stated that iTraxx, the credit default swap indices on European corporate names, would be subject to clearing 60 days after an eligible DCO offers iTraxx indices for clearing. On February 25, the CFTC received notice that ICE Clear Credit LLC began offering customer clearing.

⁴ I.e., a “third-party subaccount,” which is defined as an account that is managed by an investment manager that (i) is independent of and unaffiliated with the account’s beneficial owner or sponsor, and (ii) is responsible for the documentation necessary for the account’s beneficial owner to clear swaps.

The following swaps will be subject to the mandatory clearing determination:

| Interest Rate Swap Class | Credit Default Swap Class |
|--|--|
| Fixed-to-Floating Swap (USD, Euro, Sterling and Yen) | North American Untranch CDS Indices (CDX.NA.IG and CDX.NA.HY) |
| Basis Swap (USD, Euro, Sterling and Yen) | European Untranch CDS Indices (iTraxx Europe, iTraxx Europe Crossover and iTraxx Europe HiVol) |
| Forward Rate Agreement (USD, Euro, Sterling and Yen) | |
| Overnight Index Swap (USD, Euro and Sterling) | |

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