

Alert

The New ISDA Protocol: What Investment Managers Need to Know

June 12, 2013

Investment funds (or investment managers on their behalf) may now adhere to the ISDA March 2013 DF Protocol Agreement (“Protocol 2.0”). Protocol 2.0, as with the ISDA August 2012 DF Protocol (the “August Protocol”), is an efficient means for swap dealers to comply with certain new Commodity Futures Trading Commission (“CFTC”) rules applicable to bilaterally negotiated swap transactions. Adherence to the Protocol 2.0 is in addition to, and not in lieu of, adhering to the August Protocol. Protocol 2.0 provides a mechanism for compliance with three separate CFTC rules.¹ One rule, in particular, regarding trading documentation and reconciling trade data² (the “Documentation Rules”) is relevant to investment managers (and the funds they manage) and is the subject of this *Alert*. The final rule was published in the Federal Register on Sept. 11, 2012,³ and will be effective on July 1, 2013.⁴ If an investment fund were to adhere to Protocol 2.0, it would incorporate additional terms into their existing swap documentation including, among others, valuation processes for collateral and risk management, dispute resolution provisions, portfolio reconciliation provisions, and statements regarding the dealer’s and investment fund’s status as a financial company or insured depository institution.

Process to Adhere to Protocol 2.0

The process of adherence is similar to that of the August Protocol. Investment funds may adhere to Protocol 2.0 through the [ISDA website](#) by paying a one-time fee of \$500 and submitting an adherence letter. An investment manager may adhere once on behalf of multiple investment funds that it manages. Subsequent to the submission of an adherence letter, funds may access the [Markit website](#) and submit the Protocol Questionnaire, which allows counterparties to make certain elections and fill in appropriate data.

Not Retroactively Applicable

The Documentation Rules will not apply retroactively — compliance with these rules will only be required with respect to swaps entered into after the date that the rules go into effect (currently, July 1, 2013).

¹ The three rules subject to Protocol 2.0 are as follows: (i) Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants; (ii) End-User Exception to the Clearing Requirement for Swaps; and (iii) Clearing Requirement Determination Under Section 2(h) of the CEA. To the extent that rules (ii) and (iii) are relevant to Protocol 2.0, they are not relevant to investment funds because such funds do not qualify for the end-user exemption due to their status as “financial entities.” A financial entity is defined, in relevant part, as a commodity pool, a private fund, one of certain types of benefit plans as defined under ERISA, or a person predominantly engaged in activities that are in the business of banking or in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956.

² Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55904 (Sept. 11, 2012).

³ See <http://www.gpo.gov/fdsys/pkg/FR-2012-09-11/pdf/2012-21414.pdf>.

⁴ Business Conduct and Documentation Requirements for Swap Dealers and Major Swap Participants; Extension of Compliance Date, 78 Fed. Reg. 17 (Jan. 2, 2013).

Applicability of Documentation Rules

The Documentation Rules apply only to bilaterally negotiated swap transactions. They do not apply to trades executed on a swap execution facility or designated contract market, or that are cleared on a derivatives clearing organization. The Documentation Rules do not provide parties to a swap with a basis for voiding or rescinding a swap transaction based solely on the failure of the parties to document the swap transaction in compliance with the Documentation Rules.

Trading Documentation

According to the Documentation Rules, each swap dealer must have policies and procedures reasonably designed to ensure that such dealer has certain swap trading relationship documentation with all counterparties, including investment funds, with certain terms prior to (or contemporaneously with) entering into a swap transaction. The Documentation Rules require that swap trading documentation include terms addressing events of default or other termination events, payment obligations, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation and dispute resolution. The CFTC does not require specific provisions in the trading relationship documentation to address the foregoing terms — for example, the Documentation Rules do not dictate that particular events of default must be specified in such documentation. Current market documents (such as an ISDA Master Agreement) generally satisfy many — but not all — of the Documentation Rules. Current market documents typically include events of default and other termination events, payment obligations, calculation and netting of obligations upon termination, transfer of rights and obligations, and governing law provisions.

However, the CFTC requires that certain additional provisions that are not currently included in the typical swap documentation be included. The Documentation Rules require parties to incorporate provisions, including, among others, valuation processes for collateral and risk management, dispute resolution provisions and statements regarding the dealer's and investment fund's status as a financial company or insured depository institution. Protocol 2.0 provides a means for dealers to incorporate such additional provisions.

Protocol 2.0 also provides that if funds do not have an ISDA Master Agreement (or other form of appropriate derivative documentation) in place, there is an option for a fund to incorporate by reference the form of 2002 ISDA Master Agreement (with certain elections set forth in Protocol 2.0). Protocol 2.0 would allow a fund the option to incorporate the standard 2002 ISDA Master Agreement template of terms, including standard events of default and termination events defined in the 2002 ISDA Master Agreement form. Funds may not want to elect to incorporate such form because it may not have the protections and other terms generally present in negotiated swap documentation.

Protocol 2.0 provides for the additional provisions that will need to be incorporated into the documentation between swap dealers and investment funds, including:

- **Valuation:** According to the Documentation Rules, swap dealers must have in place policies and procedures to ensure that their documentation with “financial entities” (e.g., investment funds) includes valuation processes.⁵ The valuation process may be based on objective criteria rather than internal valuation models or, if the parties agree, the valuation process may be based on a proprietary trading model.

Protocol 2.0 has a valuation methodology based upon the “Risk Valuation.” The Risk Valuation is either a process specified in writing by the investment fund and the dealer (which may be in the form of an ISDA Credit Support Annex) or, if there is no process identified, the Risk Valuation is the “risk exposure” determined by the swap dealer based on the “close-out” provisions of its ISDA Master Agreement (unless the swap dealer has elected to use a valuation provided by the investment fund counterparty).

- **Dispute Resolution:** The Documentation Rules require that trading documentation include a method to dispute any valuation provided pursuant to the valuation process. With respect to dispute resolution provisions, the CFTC states that no specific procedures have to be followed.

⁵ The concept of including “valuation” in swap documentation has been controversial for both the dealer and investment manager communities, primarily due to the possibilities that proprietary trading models would have to be disclosed and that there would be a heavy, pre-execution burden of agreeing upon a model for complex swaps, which could impede timely trading.

Protocol 2.0 provides a method of dispute resolution with respect to valuations. If the parties have agreed in writing to a specific process of dispute resolution, such dispute resolution process will govern. If the parties have not agreed to a dispute resolution provision, the swap dealer will attempt to resolve the dispute by consulting with the investment fund counterparty. If there is no resolution in a timely manner, then the swap dealer will recalculate the risk valuation by seeking four actual quotations at mid-market. If four quotations are not available, then fewer will be used and, if no quotations are available, then the swap dealer's original calculation will be used.

Protocol 2.0 states that any calculation of value and dispute of the value is only relevant for the sole purpose of complying with the risk management provisions of the Documentation Rules related to swap dealers. In addition, Protocol 2.0 clarifies that when margin regulations are published, additional agreements related to the calculation of value may be necessary. These clarifications in the text of Protocol 2.0 were added because of market participants' concerns about the potentially significant implications of providing a value in a swap for matters such as posting collateral, investor concerns, audits, potential litigation and other regulatory contexts. If investment funds wish to have an agreed-upon method to value a swap and do not currently have such a method, such method may be agreed upon outside the scope of entering into Protocol 2.0. Protocol 2.0 explicitly states that any other procedure to determine value or dispute may be agreed upon between the parties in addition to or in substitution for the procedures set forth in Protocol 2.0.

- *Orderly Liquidation Authority Under Title II of the Dodd-Frank Act:* The Documentation Rules also require a statement as to whether the swap dealer and the investment fund are "financial companies" or "insured depository institutions." In addition, the Documentation Rules require that swap dealers include a statement in documentation that if a counterparty is deemed to be a covered financial company or an insured depository institution for which the Federal Deposit Insurance Corporation has been appointed (a "covered party"), certain limitations under Title II of the Dodd-Frank Act or the Federal Deposit Insurance Act may apply to the right of the non-covered party to terminate, liquidate, or net any swap, notwithstanding the contractual agreement of the parties. Protocol 2.0 includes both of these statements, therefore satisfying the Documentation Rules.
- *Notice that Original Swap is Extinguished upon Acceptance by a DCO:* Swap trading relationship documentation, pursuant to the Documentation Rules, obligates swap dealers to provide a notice to investment funds that, upon acceptance of a swap by a derivatives clearing organization ("DCO"): (i) the original swap is extinguished; (ii) the original swap is replaced by equal and opposite swaps with the DCO; and (iii) all terms of the swap shall conform to the product specifications of the cleared swap established under the DCO's rules. This notice provision is also provided in Protocol 2.0, therefore satisfying the Documentation Rules.

Swap Confirmations

According to the Documentation Rules, swap dealers must have written policies and procedures in place that are reasonably designed to ensure that they execute confirmations with investment funds "as soon as technologically practicable" but in any event, by the end of the first business day following the date that the transaction is entered into between the parties. Protocol 2.0 addresses the timing obligation of the Documentation Rules by stating that the terms delivered by each party (provided that they match) will evidence a binding agreement. This provision in Protocol 2.0 is intended to clarify that the exchange of matching terms through an electronic messaging platform or otherwise may serve as one means for effecting confirmations within the time periods required by the Documentation Rules.⁶

Portfolio Reconciliation

The Documentation Rules require that dealers have policies and procedures in place to ensure that they enter into a post-execution process to reconcile discrepancies in the material terms of trade and valuation data with investment funds. The CFTC "prefers to permit maximum flexibility and innovation in the process" and Protocol 2.0 does not dictate a specific format or process for reconciling such data other than as discussed below. A swap dealer is required to reconcile portfolios quarterly with investment funds if such funds have more than 100 existing swaps at any time during a calendar quarter; otherwise, such reconciliation may instead be done annually.

⁶ Parts of the Documentation Rule provisions on confirmations are not addressed by Protocol 2.0.

Protocol 2.0 provides three options to funds to reconcile trade and valuation data: (i) one-way delivery of portfolio data, (ii) two-way exchange of portfolio data or (iii) reconciliation of portfolio data against a swap data repository. One-way delivery data requires that the swap dealer deliver portfolio data to the investment fund for verification. For investment funds and their investment managers, one-way delivery may be the least burdensome means in which to operationally resolve discrepancies. In the event that one-way delivery is selected, investment funds must affirm the data or identify discrepancies within two business days. Two-way exchange of portfolio data requires that each party deliver portfolio data to the other party for a reconciliation of such material terms or valuation. Alternatively, parties may reconcile their books and records against portfolio data in the swap data repository.⁷ In each case, the Documentation Rules provide that a third-party service provider may be utilized.

Portfolio Compression

Swap dealers are obligated under the Documentation Rules to compress portfolios (that is, net offsetting positions in order to reduce risk) with other swap dealers. However, swap dealers are obligated to compress the portfolios of investment funds only at the request of such fund. Investment funds may not want to compress portfolios for a variety of reasons — they have a very small number of offsetting positions, or they may have complex arrangements with different counterparties that make compression less useful. Because there is no regulatory obligation by a swap dealer to provide an option to investment fund counterparties to compress their portfolios, if funds wish to compress portfolios, they will need to request such compression. Because compression is only offered at the request of a fund, it falls outside the scope of Protocol 2.0.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

⁷ As of the date of this *Alert*, there is no swap data repository that can provide this service but it is anticipated that this service may be provided in the future.

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