



Commodity Futures Trading Commission

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Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants

The Commodity Futures Trading Commission (Commission) is adopting final rules establishing requirements for swap trading relationship documentation, swap confirmation, portfolio reconciliation and portfolio compression for swap dealers and major swap participants.

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)

Section 731 of the Dodd-Frank Act amends the Commodity Exchange Act (CEA) by adding section 4s, which sets forth a number of requirements for swap dealers and major swap participants. This final rulemaking is being promulgated pursuant to section 4s(i). Section 4s(i)(1) requires swap dealers and major swap participants to “conform with such standards as may be prescribed by the Commission by rule or regulation that relate to the timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps.” Section 4s(i)(2) expressly directs the Commission to “adopt rules governing documentation standards for swap dealers and major swap participants.”

The final rules require swap dealers and major swap participants to adhere to certain standards for the documentation of trading relationships between swap dealers, major swap participants, and their trading counterparties. Documentation of swaps is a critical component of the bilaterally-traded swaps market and has been the focus of significant domestic and international attention in recent years.

The final rules also require swap dealers and major swap participants to adhere to certain standards for the timely and accurate confirmation of swap transactions and for the reconciliation and compression of swap portfolios. Confirmation, portfolio reconciliation, and portfolio compression have been recognized as important post-trade processing mechanisms for reducing risk and improving operational efficiency. The specific confirmation, reconciliation, and compression obligations required by the final rules vary, depending upon whether the particular swap transaction or portfolio is between a swap dealer and major swap participant, or involves other types of counterparties.

Final Rules Regarding Swap Trading Relationship Documentation Requirements

The final rules regarding swap trading relationship documentation requirements do not apply to swaps that: (1) were executed prior to the compliance date of the final rules; (2) are executed on a designated contract market or executed anonymously on a swap execution facility, provided that certain conditions are met; or (3) are cleared by a derivatives clearing organization (DCO).

The final rules require each swap dealer and major swap participant to establish policies and procedures reasonably designed to ensure that, prior to entering into a swap with a counterparty, the parties have agreed in writing to all terms governing their trading relationship, including terms related to credit support arrangements, such as initial and variation margin requirements and custodial arrangements.

Swap dealers and major swap participants also must include in the swap trading relationship documentation written documentation in which the parties agree on the process for determining the value of each swap at any time from execution to the termination, maturity, or expiration of the swap, for the purposes of complying with: (1) the margin requirements under section 4s(e) of the CEA and Commission regulations; and (2) the risk management requirements under section 4s(j) of the CEA and Commission regulations.

The final rules require that the documentation must include either: (1) alternative methods for determining the value of the swap, in the event of the unavailability or other failure of any input required to value the swap; or (2) a valuation dispute resolution process. As discussed more fully below, in the section addressing the final rules relating to portfolio reconciliation, swap dealers and major swap participants must report certain valuation disputes to the Commission (and any applicable prudential regulator and/or the Securities and Exchange Commission, as applicable).

The final rules require that swap dealers and major swap participants include within the documentation a notice concerning the orderly liquidation authority under the Title II of the Dodd-Frank Act. As part of the resolution authority in Title II (and in the existing provisions of the Federal Deposit Insurance Act for insured depository institutions), the Federal Deposit Insurance Corporation is given a one business day period in which to transfer swaps and certain other contracts to a solvent third party financial institution. The final rules require that counterparties be given notice of the potential applicability of Title II.

In addition, the documentation must include a notice that, upon acceptance of a swap by a derivatives clearing organization, the original swap is extinguished and is replaced by equal and opposite swaps between clearing members and the DCO. The regulations also require that all terms of the cleared swap conform to the product specifications of the cleared swap under a DCO's rules.

The final rules require a periodic audit of the required swap trading relationship documentation, and the audit must be sufficient to identify any material weakness in documentation policies and procedures.

The final rules require swap dealers and major swap participants to obtain documentation from any counterparty seeking to exercise its rights under the end user exception from the mandatory clearing requirement under section 2h(7) of the CEA and section 39.4 of the Commission's regulations. The documentation must include: (1) the identity of the counterparty; (2) that the counterparty has elected not to clear a particular swap; (3) that the counterparty is a non-financial entity; (4) that the counterparty is hedging or mitigating a commercial risk; and (5) that the counterparty generally meets its financial obligations associated with non-cleared swaps. However, if the swap dealer or major swap participant obtains documentation showing that the counterparty has already provided certain information in accordance with section 39.6 of the Commission's regulations, then only the first two categories of information must be documented.

Final Rules Regarding Swap Confirmations

The final rules regarding swap confirmations do not apply to a swap transaction: (1) executed on a swap execution facility or designated contract market, provided that the rules of the swap execution facility or designated contract market establish that confirmation of all terms of the transaction shall take place at the same time as execution; or (2) submitted for clearing by a DCO, provided that (i) the transaction is submitted for clearing as soon as technologically practicable, but no later than the times set forth in the rule, and (ii) confirmation of all terms of the transaction takes place at the same time as the transaction is accepted for clearing.

With respect to swap transactions with a person who is a swap dealer or major swap participant, the final rules require each swap dealer and major swap participant to execute a confirmation for the swap transaction as soon as technologically practicable, but no later than the time periods set forth in the rule.

With respect to swap transactions with a person who is not a swap dealer or major swap participant, the final rules require each swap dealer and major swap participant to send an acknowledgment of the transaction as soon as technologically practicable, but no later than the time periods set forth in the rule. For each such transaction, the swap dealer or major swap participant must establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes a confirmation as soon as technologically practicable, but no later than the time periods set forth in the rule.

The procedures must include an obligation to furnish to, or receive from, its prospective counterparty, upon request, a draft acknowledgement specifying the terms of the swap transaction (other than pricing and the terms to be definitively agreed to at execution), prior to execution.

In prescribing the confirmation time periods discussed above, the final rules establish a staggered compliance schedule, based on the type of swap and whether the swap dealer or major swap participant executed the swap transaction with another swap dealer or major swap participant.

Finally, a swap dealer or major swap participant must make and maintain certain records of the required acknowledgements and confirmations.

Final Rules Regarding Portfolio Reconciliation

The final rules require swap dealers and major swap participants to engage in portfolio reconciliation with respect to swap transactions, other than those that are cleared by a DCO. The required portfolio reconciliations could be performed bilaterally by the counterparties or by qualified third parties, and the counterparties are required to agree, in writing, to the terms of the reconciliation.

Swap dealers and major swap participants must reconcile swap portfolios with other swap dealers or major swap participants daily, weekly, or quarterly, depending upon the size of the particular swap portfolio. Discrepancies in material terms identified as part of a portfolio reconciliation process must be resolved immediately. Swap dealers and major swap participants must establish, maintain, and follow written policies and procedures reasonably designed to resolve any valuation discrepancy (of 10% or greater) as soon as possible, but no later than five business days. The policies and procedures also must identify how the swap dealer or major swap participant will comply with any variation margin requirements under section 4s(e) of the CEA and Commission regulations pending resolution of such discrepancy. The final rules do not prescribe any specific procedures that must be followed to resolve a discrepancy in valuation.

For swap portfolios involving a counterparty that is not a swap dealer or major swap participant, the final rules require that swap dealers and major swap participants establish written policies and procedures to perform portfolio reconciliation quarterly or annually, depending upon the size of the particular swap portfolio. The final rules do not, however, prescribe deadlines for the resolution of discrepancies in the material terms or valuation of swaps. Instead, swap dealers and major swap participants must establish written procedures that are reasonably designed to resolve identified discrepancies in a timely fashion.

Further, swap dealers and major swap participants must notify the Commission and any applicable prudential regulator (and the Securities and Exchange Commission, for security-based swaps) of any swap valuation dispute in excess of \$20,000,000 (or its equivalent in any other currency) if not resolved within: (1) 3 business days, if the dispute is with a counterparty that is a swap dealer or major swap participant; or (2) 5 business days, if the dispute is with a counterparty that is not a swap dealer or major swap participant.

Finally, the final rules require that swap dealers and major swap participants retain records of each portfolio reconciliation.

Final Rules Regarding Portfolio Compression

The final rules establish certain offset and portfolio compression requirements and related recordkeeping obligations for swap dealers and major swap participants. The requirements and obligations do not apply to swaps cleared by a DCO.

With respect to portfolios among swap dealers and major swap participants, each swap dealer and major swap participant must establish, maintain, and follow written policies and procedures for: (1) terminating each fully offsetting swap in a timely fashion, when appropriate; (2) periodically engaging in bilateral portfolio compression exercises, when appropriate; and (3) periodically engaging in multilateral portfolio compression exercises, when appropriate.

The final rules do not mandate portfolio compression exercises for swaps between a swap dealer or a major swap participant and other types of counterparties. Instead, swap dealers and major swap participants must establish, maintain, and follow written policies and procedures for periodically terminating fully offsetting swaps and for engaging in portfolio compression exercises, to the extent requested by the counterparty.