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Derivative documentation
Navigating the maze

Introduction

With the immediate risk of financial armageddon having receded and the global economy showing increasingly strong signs of recovery, the next 24 months is likely to see a spike in demand for legal and paralegal capacity as the financial services industry attempts to assimilate post-crisis reforms into 'business-as-usual' processes. Driven both by regulatory requirements and competitive advantage opportunities, the need to amend documentation to reflect life in a new reality will manifest itself in three main ways:

- client outreach;
- contract negotiation; and
- data extraction.

An examination of some of the main areas of regulation highlights the resourcing challenge that lies ahead.

Derivatives Trading

EMIR

The negotiation of portfolio reconciliation and dispute resolution arrangements with clients unable or unwilling to fit within the constraints of the ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol will continue and, in the UK at least must be completed by 30 April 2014. At the same time, EMIR counterparty classification remains a thorn in the side of the industry, necessitating a large degree of client outreach, despite the existence of the British Bankers' Association methodology for the consistent classification of EMIR counterparties and ISDA's EMIR Counterparty Classification Tool and 2013 EMIR NFC Representation Protocol.

Before the heat associated with EMIR counterparty classification and risk mitigation fully abated, focus inevitably shifted to EMIR trade reporting. The obligation to report commenced on 12 February 2014 with respect to all asset classes.

Despite the publication of the ISDA/FOA EMIR Reporting Delegation Agreement and the assistance provided by ISDA's "Reporting Guidance Note",[1] firms should not underestimate the amount of time and resource required to comply with EMIR reporting obligations, particularly for those which intend to offer delegated reporting services. Many aspects of the relationship between reporting parties must be defined and confirmed, including:

- Reporting roles and responsibilities;
- The nature of the data to be reported;
- Whether data is to be masked or not reported;
- Legal Entity Identifiers; and
- Consents to disclosure/confidentiality waivers.

Unfortunately, there will be no ISDA protocol to assist efforts in this area.

Later this year, will come the small matter of EMIR clearing, a process which will require the industry-wide negotiation of new documentation, such as the ISDA/FOA Client Cleared OTC Derivatives Addendum and its associated Credit Support Annexes, the FOA Clearing Module and/or the SwapClear Client Clearing Standard Terms. At the same time, firms must be mindful of their obligations to disclose to clients fees associated with clearing services[2] and to:

- offer clients a choice between individual client accounts or omnibus client accounts;
- publicly disclose the levels of protection and costs associated with different levels of segregation; and
- describe the main legal implications of different levels of segregation[3] a process with which the FOA/ISDA Clearing Member Disclosure Agreement is designed to assist.

1. An attachment to the ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol
2. Pursuant to EMIR Article 38(1)
3. EMIR Article 39(7)

MiFID II

Agreement over MiFID II has now been reached. In its final form this initiative will hugely impact derivatives which are currently traded OTC but will need to be executed via a platform/exchange going forward within the EU, requiring firms to contact clients in order to document new requirements regarding:

- terms of business;
- conduct of business rules;
- execution-only services;
- cross-selling practices; and
- title transfer collateral arrangements.

Dodd-Frank

In the US, although the central clearing of derivatives is more advanced than in the EU, documentation and data analysis requirements persist. Potentially, thousands of clearing relationships documented under the FIA-ISDA Cleared Derivatives Execution Agreement will have to be amended due to their inconsistency with CFTC guidance requiring SEFs to allow market participants full access to its trading systems or platforms. Elsewhere, efforts to comply with the CFTC's cross-border guidance[4] continue, with firms looking to confirm client status as a "US Person" with the assistance of ISDA's Cross-Border Swaps Representation Letter for US Banks, published on 24 September 2013, and tailor their obligations using ISDA's Non-U.S. DF Agreement, published on 15 November 2013.

More recently, the CFTC's final rules on the protection of collateral of counterparties to uncleared swaps[5] will create further client outreach requirements, demanding that swap dealers and major swap participants:

- notify each counterparty of their right to require that initial margin be segregated;
- identify at least one "creditworthy non-affiliate" and potentially other "independent" legal entities that may act as custodian; and
- provide information regarding the price of segregation for each custodian.

Looking further ahead, the Volcker Rule, due to come into force on 21 July 2015, will prohibit banking entities from:

- engaging in short-term proprietary trading of securities, derivatives, commodity futures and options; or
- owning or sponsoring hedge funds or private equity funds.

If they wish to take advantage of exemptions related to market-making, underwriting or hedging, Volcker Rule compliance will require firms to muster the resource necessary to be able to generate, interpret and independently validate entirely new views of trading activity.[6] Unfortunately, compliance with the Volcker Rules is not optional. Therefore, even for those firms that do not wish to rely on Volcker exemptions, a significant amount of legal and paralegal resource will be required in order to effect large scale business novation or run-off.

Too big to fail

In the UK, the Financial Services (Banking Reform) Bill received Royal Assent on 18 December 2013. Whilst much of the detail will be finalised in secondary legislation, it will undoubtedly trigger a large scale data extraction and analysis programme within the banking industry. Affected firms will be required to allocate client relationships either inside or outside of the ring-fence, a process which will largely be mirrored (if not duplicated) under the EU proposal on structural reform.[7] More generally, the process of bank subsidiarisation, triggered by developments in thought around 'single point of entry' versus 'multiple point of entry' resolution will create a further need to amend contractual relationships with clients as banks hive off local operations and do away with branch structures. Last, but by no means least, the data mining requirements associated with recovery and resolution planning are set to become even more focussed with the Prudential Regulation Authority's publication of Policy Statement PS8/13, which came into force on 1 January 2014. This will require firms to assemble the resource necessary in order to generate, validate and update detailed reporting on many aspects of a bank's business, including derivatives and securities financing transactions, debt issuances, guarantees and security arrangements.

Derivative documentation

On 2 September 2013, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions published their long-awaited final policy document dealing with "Margin requirements for non-centrally cleared derivatives". In advance of the phase-in of these requirements commencing on 1 December 2015,[8] these rules will trigger industry wide amendment of Credit Support Documents in order to reflect new requirements regarding:

- initial margin and variation margin;
- Minimum Transfer Amount limitations;
- rehypothecation rights; and
- "highly liquid" collateral.

4. i.e. the "Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations" published by the CFTC on 26 July 2013
5. 17 CFR Parts 23 and 190, published on 6 November 2013
6. For example, whether underwriting or market-making activities exceed the reasonably expected near-term demands of customers
7. Albeit between "Trading Entity" and "Deposit Bank"
8. We expect a consultation paper from EBA/ESMA/EIOPA in March/April

These changes will be preceded by more general amendments to existing portfolios of ISDA Master Agreements, all of which will have resourcing consequences for the industry. ISDA recently[9] committing to facilitate the inclusion of a standard provision in which counterparties agree to a short-term suspension of termination rights following the entry of a counterparty into insolvency or resolution, a requirement consistent with 'Living Wills' legislation in many jurisdictions. In the near future, ISDA will also publish recommended amendments to Section 2(a) (iii) of the ISDA Master Agreement, with the ability of a party to withhold performance following the occurrence of an event of default affecting its counterparty likely to be limited in time to 90 days.

Elsewhere, FATCA will remain a driver for further amendments to existing ISDA Master Agreements, creating a need to clarify definitions of "Indemnifiable Tax" and to streamline CSA eligible collateral to exclude US obligations for non-FATCA compliant clients. More generally, repapering of documentation as a result of the discontinuation of various benchmark interest rates will continue. Once finalised, the Fourth Money Laundering Directive will create a requirement for amendments to customer due diligence requirements and the revision of the FCA's client money rules in the UK will lead to the drafting and negotiation of revised standard terms of business.

Competitive advantage: turning data into dollars

The need for legal and paralegal resource over the next 24 months will not be driven solely by considerations of regulatory compliance. There is an increasing recognition within the industry that data is the new competitive frontier. This accounts for the increasing emphasis placed on the ability to price derivatives transactions more accurately in terms of Economic Value Adjustment (EVA), comprising:

- **Credit Value Adjustment (CVA):** a quantitative measure of counterparty credit risk;
- **Funding Value Adjustment (FVA):** the funding cost (or benefit) to a firm when hedging, in the interdealer market, the uncollateralised element of a trade executed with a client;
- **Replacement Value Adjustment (RVA):** the valuation of contractual ratings downgrade triggers; and
- **Collateral optimisation:** avoiding over-collateralisation and overly-frequent collateralisation as well as the identification of the 'cheapest to deliver' collateral.

Firms with a robust data strategy which allows them to accurately and dynamically price EVA into derivative transactions prior to trading will be able to safely move beyond traditional (and usually more conservative) limit-setting approaches to risk management. The ability to accurately and efficiently price risk, manage and hedge exposures and capitalise on trading opportunities will be improved as a result. However, a critical element of any successful EVA strategy is the ability to efficiently access the unstructured data locked within portfolios of derivative documentation such as ISDAs and particularly CSAs. Those without the resource and expertise to properly understand, retrieve and present this information will lose out in the long run.

How we can help

Deloitte and DRS provide a flexible and scalable resourcing utility to undertake client outreach, document negotiation and data extraction projects, either on-site or off-site and across time zones. Allying subject matter expertise, delivery capabilities and technology accelerators, we provide a complete end-to-end managed solution at a competitive price point. In an environment of budgetary restraint, our services take the form of a menu of options, all designed to fit seamlessly into a client's existing operational processes. They are the perfect solution for those firms without the permanent headcount to resource projects of this type or the appetite to recruit, train and manage significant numbers of temporary staff.

We have the skill, the scale and the flexibility to assist you in navigating the maze. If you would like to discuss your needs in this area or more generally, please reach out to your usual contact.

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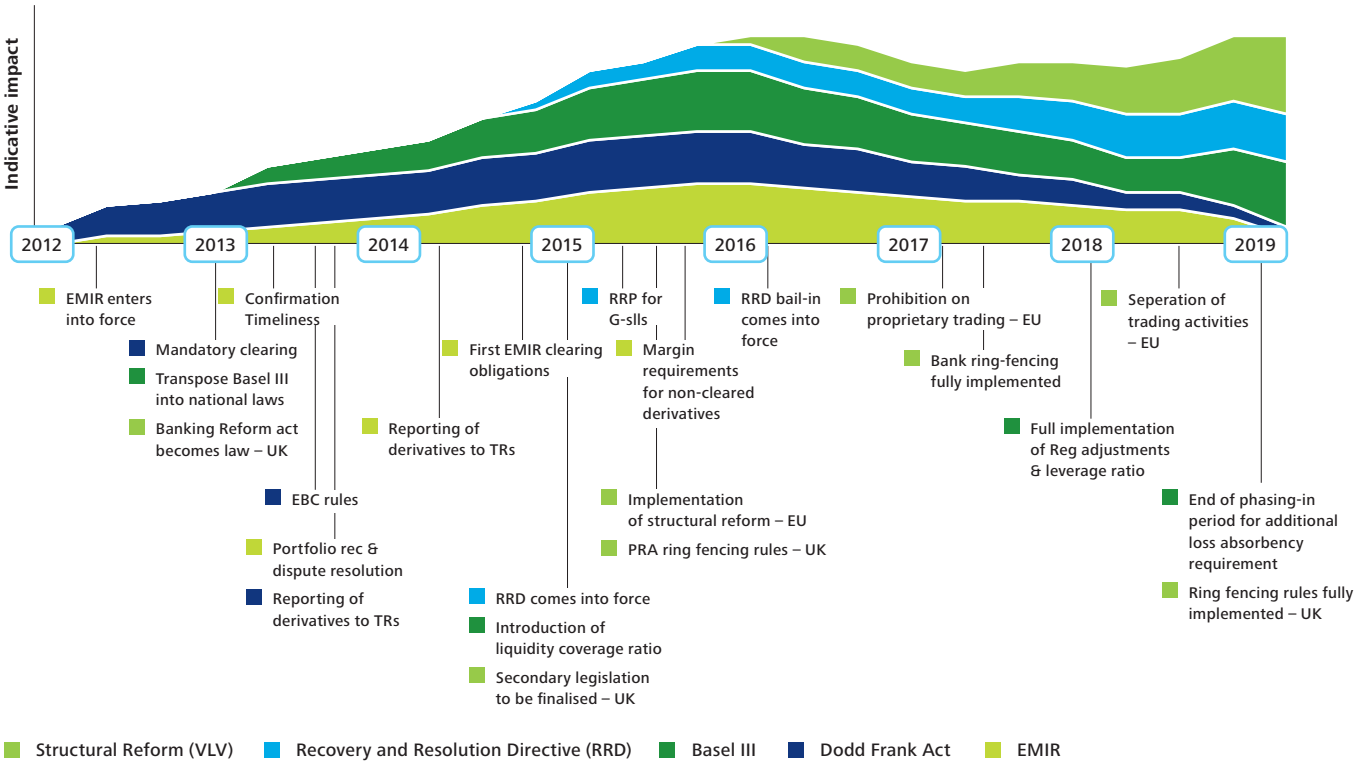
9. See ISDA statement published on 6 November 2013

The scale of the task



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