FundsTalk

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We are pleased to offer this issue of FundsTalk, Kramer Levin's newsletter devoted to discussing legal issues facing alternative asset managers and funds. Since 2008, the alternative asset market has seen a broad convergence of previously distinct asset classes and strategies, such as private equity, hedge funds, debt and claims trading, etc., into a single class — alternative assets. Extending that theme of convergence, this newsletter focuses on multi-disciplinary themes that affect all asset managers, with particular attention paid to new developments and changes in the legal landscape in which the industry operates. We hope you find the information contained in this newsletter to be helpful and profitable, and welcome your thoughts and suggestions.

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The contents of this FundsTalk are intended for general informational purposes only, and individualized advice should be obtained to address any specific situation.

It's All in the Name — Building a Successful Brand

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When a hedge fund or private equity fund is initially formed, its reputation is inextricably linked to that of its founders. As with any successful business, however, the value of hedge and private equity fund names over time will evolve from the goodwill and reputation that they have developed, distinct from the founder's individual reputation. To maximize this value, hedge and private equity funds would be best served to plan and execute a tailored trademark strategy to successfully brand their company and fund names.

A well-developed trademark strategy begins by selecting a name that is protectable, differentiates you from your competitors, communicates your core message, and avoids violating the rights of others. While investment advisers and management companies of hedge and private equity funds often don't think about trademarks outside of the valuation of investment opportunities for their clients, creating and protecting your own intellectual property will benefit you as you strive to build your reputation, mature beyond the first generation of founders and/or position yourself for growth through strategic acquisitions, sale or investments. Whether you are in the process of organizing a fund or have been operating for years, trademark issues should be considered and tailored alongside other operational and legal risk assessments.

1. Differentiation and Uniformity in Messaging

Select management company and fund names that are distinct, build on a common term, and/or are associated with a theme, distinguish you in the marketplace and position you as a cogent brand. For example, building a family of funds around the term **ATHENA**, the Greek goddess of wisdom, would associate these positive attributes with your funds. Using **ATHENA CAPITAL MANAGEMENT GP** for the general partner name, **ATHENA CAPITAL MANAGEMENT LLC** for the investment adviser's name, and fund names such as **ATHENA MASTER FUND** and **ATHENA OVERSEAS FUND**, unifies your various entities and funds, and

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It's All in the Name — Building a Successful Brand

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immediately communicates to investors that all of the funds emanate from the same source. Selecting a unique theme, such as Indian spice names for a fund dedicated to Indian investment, would have a similar effect.

2. Strength of Branding: Avoid Descriptive Terms

A descriptive term is a term that directly describes a characteristic or quality of the underlying product or service. For example, Healthy Choice for vegetables, and The Children's Place for a kids' clothing store, are both legally descriptive because they immediately convey

Descriptive marks are attractive from a marketing perspective, as consumers know precisely what is being offered without the seller needing to educate them. However, from a legal perspective, descriptive marks are accorded limited protection because the law does not permit one party to monopolize a term that others need to use.

information about the goods/services being sold. Words like Best and Ultimate are also descriptive in that they indicate a quality of goods/services, rather than identify their source. Likewise, in the example Bank of Boston, Bank is descriptive and Boston is geographically descriptive (rendering the mark as a whole descriptive), because these terms immediately communicate aspects of the underlying services, namely banking services from Massachusetts.

Descriptive marks are attractive from a marketing perspective, as consumers know precisely what is being offered without the seller needing to educate them. However, from a legal perspective, descriptive marks are accorded limited protection because the law does not permit one party to monopolize a term that others need to use. In this regard, descriptive marks can be registered as trademarks only after they have acquired recognition by consumers, known as "secondary meaning." Even then, similar marks will be permitted to exist so long as the marks are different enough to avoid confusion. By way of example, Home Depot and Office Depot are both legally descriptive marks in that they immediately communicate information about the stores (*i.e.*, a Depot for Home/Office goods). While these marks are protectable because they have been used and advertised to such an extent that consumers associate each term with only one source, the scope of protection for each mark is limited such that the other, unrelated mark, is permitted to coexist. Similarly, Boston Private Bank & Trust Company is unrelated to Bank of Boston referenced above, yet both coexist in the banking space.

It goes without saying that funds want to use descriptive terms such as Partners, Value Fund and Global Equity Fund to communicate placement in the fund's structure (in the case of Partners) or to identify the focus of the fund (in the case of Value Fund and Global Equity Fund). To optimize your brand value, however, it is best to incorporate a distinctive term to distinguish your company/funds from others. The level of protection accorded to this additional term will depend in significant part on the composition of the term itself.

More specifically, a made-up term, known legally as a "fanciful" term — such as Drillogy for funds dedicated to oil investments — would be most protectable, in that such term did not exist before you created it (think Xerox, Kleenex). A term that exists already but is unrelated to hedge funds, known legally as an "arbitrary" term — such as Peacock for a family of funds having nothing to do with birds — also has a high level of protection, in that while you couldn't stop use of the term for its actual meaning, you could stop others' use in your unrelated field (think Apple for computers). A term that communicates something about the underlying services but requires imagination to get there, known legally as a "suggestive" term — such as Safari for a fund dedicated to African investments — is accorded less protection than a fanciful or arbitrary term, though still more protection than a descriptive term. When selecting a mark, these categories should be kept in mind, as they directly impact the strength and enforceability of your mark.

3. Due Diligence Now Can Save Money Later

Once you find a term you like, you should determine whether any third parties are using an identical or substantially similar term for the same or related services in the U.S. If you plan to use your mark internationally, *e.g.*, by operating a fund abroad or securing investments

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abroad, you would be best served to search your mark in the countries in which these activities are expected to occur. Considering international markets early on will avoid your building up goodwill and reputation in a mark in the U.S., only to discover years later that you cannot use or register it abroad and thus need to curb your expansion or expand under a different name.

A trademark search is conducted through counsel, with the underlying report generated by an outside search company. Since SEC regulations and the private nature of funds often renders information on funds hard to find, a trademark search is useful in that it provides a comprehensive listing of available information from which counsel may analyze the level of risk presented by prior third-party marks or company names. A trademark search garners information from U.S. and state trademark registers, domain name registries, industry directories, and internet databases. This process enables counsel to quantify the risk of selecting a particular mark, and permits you to make an informed business decision as to how to proceed. Counsel would then work with you to tweak your name/mark to minimize risk, or may guide you to choose an alternative name/mark altogether. While changing course is never welcomed, doing so before you build a reputation is better than needing to defend a lawsuit and/or change your name once it's already known in the industry. If the risk identified by the trademark search is deemed reasonable, federal trademark registration should be sought.

4. Protect Your Assets: Register Your Mark

Federal registration of a trademark provides many advantages, and is a valuable tool to combat infringement by third parties. For example, a federal trademark registration: (1) grants the exclusive, nationwide right to use the registered mark with the goods/services identified in the registration; (2) establishes the presumption that the registrant is the owner of the mark, and the mark is valid; (3) permits the mark to be included in the U.S. Patent and Trademark Office ("PTO") records, making it more likely that third parties will have notice of the mark and therefore not adopt a similar mark; (4) provides a basis to sue for federal trademark infringement; (5) provides a basis to assert rights against a domain name similar to the registered trademark; (6) assists enforcement efforts by establishing credibility; and (7) adds value to the registrant by creating an appreciable asset.

Without a federal registration, your company would have at most "common law rights" in its name/mark(s), which rights must be established through evidence of use. Common law rights are limited to the geographic region in which they are known, which may have practical implications for funds whose reputations are not known nationwide. For example, if you manage a fund in Connecticut, and are not known in California, it would be difficult for you to prevent operation of a California fund under a similar name. Likewise, your expansion to California could be precluded in light of the California fund's prior rights in that region. If you own a federal registration, nationwide rights are presumed and reputation need not be proven.

5. Proving Use

U.S. trademark law permits a trademark application to be filed based on an "intent to use the mark in commerce." As such, it is possible — and advisable — to apply to register company and fund names before a fund is launched, so as to stake your ground. That said, for a U.S. applicant to perfect its application into a registration, the applicant must show that the mark is in use in interstate commerce. Documented proof of use must be submitted to the PTO, which documentation becomes publicly available on the PTO's website.

Funds use marks in a number of ways that constitute cognizable trademark use, including in connection with offering memoranda, monthly letters to investors, and materials distributed to potential investors. In light of the public disclosure of these documents upon submission to the PTO, special attention should be paid to redacting any information (*e.g.*, index comparisons) that you do not want to be publicly available.

6. Conclusion

A fund's reputation is one of its most significant assets. While you rely on your managers to maintain that reputation through performance, choosing distinct and protectable names and marks for your company and funds can distinguish you from competitors, and solidly position you in the minds of investors, potential investors and the industry. You strongly protect your investors' assets. You should also protect your own. ■

Compliance: Regulators Are Focusing on…Everything

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As registered advisers plan for their upcoming compliance year including annual reviews and testing, compliance officers should be aware of the areas of focus currently of interest to regulators. The Securities and Exchange Commission ("SEC"), the Commodities Futures Trading Commission ("CFTC"), the Financial Industry Regulatory Authority ("FINRA") and state regulators all routinely publish information about weaknesses and deficiencies in their examinations of advisers and other regulated entities. FINRA and CFTC divisions routinely issue annual letters identifying common problems and recommending curative actions, while the SEC often identifies deficiencies in speeches, enforcement actions and other materials issued through its compliance outreach program. FINRA often announces its focus areas for enhanced oversight or supervision of particular business practices. The North American Securities Administrators Association ("NASAA") routinely summarizes common deficiencies identified by state regulators in their enhanced state examination and enforcement programs. Recent enforcement actions and orders have also reflected that compliance is receiving greater attention from all regulators. While all of these regulators have different jurisdictions, there are some common themes in their examination focus, and overlapping areas of concern.

Advisers should review their existing compliance structures with an eye to identifying and correcting deficiencies, implementing compliance policies and procedures, and improving the efficiency of internal compliance reviews, including forensic testing, to detect gaps and ensure proper administration of compliance procedures.

Advisers should review their existing compliance structures with an eye to identifying and correcting deficiencies, implementing compliance policies and procedures, and improving the efficiency of internal compliance reviews, including forensic testing, to detect gaps and ensure proper administration of compliance procedures. Advisers that establish and document a "culture of compliance" and embrace compliance obligations will be better prepared for regulatory examinations, and are likely to receive a more favorable outcome.

SEC Focus Areas

The National Exam Program

Recently, the SEC sent a letter to newly registered advisers introducing its new National Exam Program ("NEP"), which is administered by the Office of Compliance Inspections and Examinations. The NEP is a coordinated effort by the SEC to conduct consistent risk-based examinations of registered investment advisers. The SEC identified several "higher risk" areas of focus for newly registered investment advisers, and described what SEC examiners will be looking for:

- *Marketing*, including materials used to solicit new investors or retain existing investors (such as regular newsletters or performance reports). SEC staff will look for false or misleading statements about the adviser's business or performance record, and statements or omissions of material facts that could be manipulative, fraudulent, or deceptive. SEC staff also will review how advisers solicit investors for private funds, including through placement agents.
- *Portfolio Management.* Advisers are obligated to act in the best interests of their advisory clients and to identify, mitigate, and disclose any material conflict of interest. SEC staff will look at advisers' portfolio decision-making practices, including allocating investment opportunities and trade allocations and aggregations, and particularly whether practices in these areas are consistent with disclosures provided to investors.
- *Conflicts of Interest.* SEC staff will review advisers' procedures and controls to identify, mitigate, and manage conflicts of interest, specifically: allocation of investments, fees, and expenses; sources of revenue; payments made by private funds to advisers and related persons; employees' outside business activities and personal securities trading; and transactions by advisers with affiliated parties. Review of these areas will likely include whether the advisers' supervisory procedures are

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implemented to ensure conflicts of interest are identified and appropriately elevated.

- *Safety of Client Assets.* SEC-registered advisers that have "custody" of client assets must satisfy the Custody Rule (Rule 206(4)-2). SEC staff will review advisers' compliance with the Custody Rule and related rules designed to prevent theft or loss of client assets. SEC staff also will review independent audits of private funds for consistency with the Advisers Act custody rule.
- *Valuation.* Advisers must have effective policies and procedures to properly value client holdings and assess fees based on those valuations. SEC staff will review advisers' valuation policies and procedures, including their methodology for fair valuing illiquid or difficult-to-value instruments. SEC staff also will review advisers' procedures for calculating management and performance fees, and allocating expenses to private funds.

Enforcement Actions

In recent years, the SEC has focused sharply on compliance, and has imposed sanctions and fines for failure to adopt, implement or follow compliance programs and procedures, even in cases where there has been no showing of monetary harm to investors. The SEC has also taken action against compliance and operating personnel, portfolio managers and attorneys personally for specific compliance failures, including failing to follow valuation procedures, failing to collect code of ethics reports, and failing to correct procedures that were known to be defective. Recently, the SEC sued a private fund adviser alleging that the adviser's failure to mark down impaired assets inflated management fees by more than $10 million. In another case, the SEC sued a business development company and its officers for failing to properly "fair value" some investments and overstating its net asset value. This focus on valuation has been building for several years, and SEC staff have said they will continue to focus on valuation and fees.

Other recent cases have involved misrepresentations of qualifications, undisclosed compensation and failing to disclose adverse regulatory examination outcomes. These cases reflect the SEC's focus on initial disclosures to investors, now contained primarily in Form ADV and the Firm Brochure. In 2011, the SEC announced that it would focus its reviews on managers providing "aberrational performance" which it defined as a 3% or greater return over the comparative market index. Advisers with "aberrational performance" would be subjected to some greater scrutiny by the SEC and are more likely to be examined. The SEC is always focused on fee disclosures as well: management and advisory fees, expenses passed on to investors, and, when funds are placed through brokers, disclosures to satisfy the cash solicitation rule.

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In all of these areas, an adviser's disclosure to its clients and investors will be a key part of the review. SEC-registered investment advisers to pooled investment vehicles are subject to a special anti-fraud rule, Rule 206(4)-8, which covers all statements made by the adviser, and is not limited to statements in connection with the purchase or sale of a security. For these advisers, the anti-fraud rule is an additional ground for enforcement actions.

CCO Outreach

The SEC operates a compliance outreach program designed for Chief Compliance Officers ("CCOs") of investment advisers. CCOs can find more information about this program and subscribe for updates and notifications at http://www.sec.gov/info/complianceoutreach_ia-funds.htm.

FINRA

FINRA annually issues a letter summarizing its regulatory and examination priorities. Certain topics make encore

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appearances and help isolate "risk areas" for compliance focus. For 2012, FINRA specified several practices involving retail customers of regulated broker-dealers that also apply to private fund investors. They are:

- *Business Conduct Issues* — including full disclosure of material risks, pricing and overcharging, and suitability of products; and what brokers say about yield chasing, liquidity, cash flows and financial conditions.
- *Update for New Rules* — FINRA's new Suitability Rule (Rule 2111) and Know Your Customer Rule (Rule 2090), which became effective in 2012, require brokers to obtain more information from customers, and codify a long-standing position that brokers must perform and document their reasonable due diligence to understand a product or strategy they recommend to their clients. FINRA identified specific risk areas for broker due diligence, and advisers should consider whether their disclosures in these areas are clear and understandable:
  - *RMBS and CMBS* — prepayment options and their effect on re-investment risk and yield; risk variations among different tranches with different risk profiles; and the opacity of collateral pools and lack of a secondary market.
  - *Non-Traded REITS* — although these securities offer diversification, they may lack price transparency and liquidity, may have valuation issues, and the source of funds for distributions to investors may not be clear.
  - *Municipal Securities* — some issuers may not provide timely disclosure and complete financials.
  - *Exchange Traded Products* — some complex exchange traded funds use optimization strategies that include exposure to synthetic derivatives and tracking error, which is exacerbated by leverage.
  - *Structured Securities* — liquidity risk and credit risks may make them unsuitable for retail investors, but they appear attractive based on yield projections.
  - *Unregistered Securities in Secondary Markets* — fund structures are sometimes used to effectuate these investments, which FINRA considers an "added layer" of fees.
- *Information technology and cyber security* — security and authentication for web-facing systems is an increasing concern for firms that accept e-mail instructions to transmit or withdraw funds.

State Regulators

NASAA recently released a list of best practices for investment advisers that could minimize the risk of regulatory violations. These best practices came from a review of 825 examinations of state-registered investment advisers by 45 state regulators during 2011. NASAA identified deficiency areas, and specifically areas of trouble for private fund advisers (who are not federally regulated advisers). The top five areas of deficiency were:

FINRA's new Suitability Rule (Rule 2111) and Know Your Customer Rule (Rule 2090), which became effective in 2012, require brokers to obtain more information from customers, and codify a long-standing position that brokers must perform and document their reasonable due diligence to understand a product or strategy they recommend to their clients.

- *Registration* — primarily inconsistencies between the two parts of Form ADV, and failing to amend Form ADV in a timely manner. Nearly 60% of advisers had a registration deficiency; nearly 70% of private fund advisers had a deficiency in this area.
- *Books and Records* — failing to maintain client suitability information, failing to safeguard client records and data, and failing to back up data. Over 45% of advisers had a deficiency in this area; over 40% of private fund advisers had deficiencies in this area.
- *Unethical Business Practices* — including missing or no contracts and other contract-related issues, altered documentation, and documents signed in blank. Over 35% of advisers had a deficiency in this area, although the percentage was lower for private fund advisers.
- *Supervision* — including inadequate or missing supervisory or compliance procedures, inadequate

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supervision of personal trading, and lack of supervision over remote locations.

- *Advertising* — deficiencies primarily involved correspondence, business cards and the use of' the term "RIA," and website presentations. In the area of performance reporting, the primary deficiencies involved the use of benchmarks, indices and calculation methodologies, misleading presentations or inaccurate presentations of results.

With respect to pooled investment vehicle advisers:

- Nearly half had deficiencies involving valuation, cross-trades or preferential treatment; and
- More than 40% had a deficiency relating to a claim for exemption from registration.

What Should Advisers Do Now?

In planning for their annual compliance review, advisers should focus on the areas of interest identified by these regulators. Helpful steps would include:

- Review your compliance program and perform forensic testing to make sure it is being implemented and that required reports (especially Code of Ethics reports) are being completed, collected and reviewed. All reviews to satisfy the compliance program should be documented.
- Compare Form ADV (including the Firm Brochure) with offering materials and marketing materials (including newsletters and websites), and ensure there are no inconsistent statements. Verify portfolio manager information in the Supplemental Brochure.
- Review all offering materials and ensure that the risks of the specific investment strategies are fully disclosed and that the risk disclosure reflects current market practices and information. Ensure appropriate investor risk warnings are included on offering materials, and that only qualified investors are receiving materials. Ensure that marketing materials are not conflicting with offering materials with respect to particular investment risks.
- Consider whether disclosure could be improved regarding yield chasing, liquidity, cash flows, financial conditions, fees, expenses charged to pooled vehicles, and compensation paid, if any, with respect to placements of securities. Registered advisers should ensure that the cash solicitation rule disclosure statements are being delivered.
- Review investment and operational policies and procedures, with a focus on valuation, allocations and preferential terms, to ensure that conflicts are identified and appropriate controls are in place. Consider implementing a training or review to ensure policies and procedures are followed.
- Review fee disclosures, contracts and fee calculations to make sure fees are properly calculated. This is an increased area of risk when fees are assessed on illiquid or hard to value investments, or when side pockets or preferential redemption arrangements are in place.

Consider whether disclosure could be improved regarding yield chasing, liquidity, cash flows, financial conditions, fees, expenses charged to pooled vehicles, and compensation paid, if any, with respect to placements of securities. Registered advisers should ensure that the cash solicitation rule disclosure statements are being delivered.

- Review client confidentiality and access procedures to ensure that appropriate controls are in place with respect to client accounts. Even if an adviser does not have actual custody of client assets, advisers need to maintain confidentiality of client information. If records are maintained electronically, ensure that access is appropriately restricted, and that records are backed up. Advisers storing records in "clouds" should ensure that they document their due diligence of the cloud provider. Advisers accepting instructions telephonically or electronically should confirm that procedures are in place to protect against unauthorized transactions.

Demonstrating the "culture of compliance" is an important part of a successful compliance examination outcome. Although not all of these focus areas apply to every investment adviser, some improvements can likely be identified. Registered advisers should ensure that they document this review as part of their annual compliance report. ■

Derivatives Regulations under Dodd-Frank — Impact on End-Users

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October 2012 marked the beginning of mandatory compliance with the new derivatives regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), more than two years after the enactment of the law. Regulators, predominantly the Commodities Futures Trading Commission (the "CFTC"), have now finalized a sufficient number of key implementing regulations to bring the derivatives market under their oversight. While the new regime primarily impacts dealers and very large market participants,[1] derivatives end-users will also be affected by Dodd-Frank.

End-users will be subject to a reporting obligation only in the limited circumstances where the swap is entered into with another end-user and the data is not timely and fully reported by an execution platform, exchange or clearinghouse.

At the beginning of 2013, among other things, all swaps will be required to be reported to swap data repositories, certain standardized swaps will have to be cleared through clearinghouses and end-users will need to have updated their trading facilities so that their dealer counterparties can comply with business conduct rules and other regulatory requirements.

This article provides an overview of the main considerations end-users need to be aware of under Dodd-Frank.[2] In particular, we address issues related to reporting and recordkeeping, clearing, swap trading documentation, margin and collateral for uncleared swaps, and various industry initiatives related to these issues. We also highlight actions that end-users should take or consider taking and the timing implications for those actions.

Reporting and Recordkeeping Requirements

End-user Reporting Obligations

Pursuant to Dodd-Frank, all existing and new swaps (cleared and uncleared) will have to be reported to swap data repositories ("Repositories"). The CFTC imposes a thorough reporting and recordkeeping regime on all market participants: swap execution platforms, exchanges and clearinghouses are responsible for reporting swaps executed or cleared on their platforms; swap dealers and major swap participants[3] ("Regulated Entities") will report transactions with end-users;[4] and, commencing on April 10, 2013, end-users will report transactions with other end-users.

End-users will be subject to a reporting obligation only in the limited circumstances where the swap is entered into with another end-user and the data is not timely and fully reported by an execution platform, exchange or clearinghouse. In that case, the two end-users will have to agree on which of them will report the data to a Repository. However, if one counterparty is a U.S. person or a financial entity and the other is not, the reporting obligation will fall on the U.S. person or the financial entity, respectively (and in that order). The end-user reporting party must initially report the swap's primary economic terms within 48 business hours,[5] and swap continuation data (*i.e.*, modifications to or extensions of the contract, changes to the swap's primary economic terms and valuation changes) within two business days.[6]

The CFTC adopted a slightly different regime for swaps entered into before the enactment of Dodd-Frank (July 21, 2010) but not terminated or expired as of that date ("pre-enactment swaps") or entered into on or after July 21, 2010 but prior to the applicable reporting compliance date for such swap and counterparty ("transition swaps").

For swaps in existence after April 25, 2011 (the date the CFTC proposed its rule) the reporting party is only responsible for reporting the minimum primary economic terms in their possession on or after that date. Furthermore, the reporting counterparty is required to report any change in the data that it initially provides to the Repository. For swaps that expired or terminated prior to April 25, 2011, information required to be reported is limited to the swap data in the reporting party's possession on or after October 14, 2010 (pre-enactment swaps) or December 17, 2010 (transition swaps).

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End-users should determine whether they are subject to reporting obligations and, if so, implement procedures to ensure compliance.

Legal Entity Identifiers
To streamline reporting, the CFTC requires that market participants be identified by a legal entity identifier ("LEI"), a number that will need to be obtained online by each market participant from the Depository Trust & Clearing Corporation ("DTCC").[7] Swap dealers will need their swap counterparties' LEI to comply with their reporting obligations under Dodd-Frank (*see* Industry Initiatives below).

All market participants must collect and maintain information and documentation regarding their swap activities and agreements. In particular, end-users will be required to keep full, complete and systematic records, together with all pertinent data and memoranda regarding their swaps, including historical swaps.

Recordkeeping Obligations
All market participants must collect and maintain information and documentation regarding their swap activities and agreements. In particular, end-users will be required to keep full, complete and systematic records, together with all pertinent data and memoranda regarding their swaps, including historical swaps. Such records include all master agreements, credit support agreements and minimum primary economic terms such as contract type, transaction date, quantity, price, buyer, seller and any other term(s) of the swap matched by the counterparties in verifying the swap. The data is required to be kept for at least five years after the expiration or termination of the swap and is subject to inspection by the CFTC. Records may be kept in any format, but must be retrievable within five business days throughout such retention period. In light of these recordkeeping requirements, end-users should review internal recordkeeping procedures and, if necessary, implement or revise applicable procedures to ensure compliance.

For swap and swaption contracts linked to the price of certain physical commodities, end-users should be aware of certain recordkeeping requirements imposed by the CFTC's large swap trader reporting rules. When the size of those contracts exceeds a certain threshold, all traders are required to keep books and records for those contracts as well as for transactions in the underlying commodity and all commercial activities and related risks hedged or mitigated by those contracts.

Confidentiality Issues
In addition to being reported, certain swaps transaction and pricing data relating to both cleared and uncleared swaps will be publicly disseminated by Repositories. However, to protect end-users' trading strategies and positions, such publicly disseminated information will not include the identities of the counterparties and notional amounts will be capped.

Amendments to swap trading facilities orchestrated by industry associations such as the International Swaps and Derivatives Association ("ISDA") will override applicable contractual confidentiality and non-disclosure obligations amongst counterparties so that Regulated Entities can comply with their reporting obligations. Because of these changes, certain end-users, such as asset managers, should review their investment management agreements with their customers to ensure that the new reporting and disclosure regime will not result in a breach of their confidentiality undertakings.

Clearing and Swap Clearing Arrangements

Clearing Requirements and Timing
Dodd-Frank mandates that swaps must be cleared through a clearinghouse if the CFTC (or other relevant agency) determines that the swap must be cleared. The CFTC clearing requirement is expected to apply to standardized plain vanilla swaps, while bespoke swaps will continue to

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be bilaterally traded and are not expected to be cleared. In determining whether a swap should be subject to mandatory clearing, the CFTC must consider a number of factors, such as market depth and trading liquidity, the existence of adequate pricing data and the availability of capacity, operational expertise, resources and credit support infrastructure at a clearinghouse to clear the contract.

A clearinghouse planning to accept swaps for clearing must submit the swap to the CFTC for a clearing determination. The CFTC must make that determination within ninety (90) days after receiving a complete submission. The CFTC is also required, on an ongoing basis, to review swaps not submitted for a clearing determination by a clearinghouse to determine if they should be subject to a mandatory clearing requirement. Such determinations are subject to a thirty (30) day public comment period.

On August 7th, the CFTC proposed its first clearing mandate for certain interest rate swaps and index credit default swaps.[8] The public comment period for the proposal expired a month later and a final clearing determination was issued by the CFTC on November 28th. Upon publication of the CFTC's final clearing determination regarding these swaps, market participants must clear such swaps in accordance with a phased-in implementation schedule, based on the identity of the counterparties to the swap and summarized in the box on the right.

In light of the CFTC's final clearing determination for those interest rate swaps and credit default index swaps issued on November 28th, compliance with mandatory clearing will commence on March 11, 2013 for category 1 entities, June 10, 2013 for category 2 entities and September 9, 2013 for all other entities.

With respect to energy swaps, clearinghouses in the U.S. have or are in the process of transitioning certain cleared energy swap products into futures contracts in order to avoid the regulatory burden imposed by Dodd-Frank and enable dealers making a market in those products to stay below the *de minimis* thresholds for purposes of registration as a swap dealer with the CFTC.

Backloading

The industry had recently expressed concerns that a narrow reading of the phased-in implementation schedule would require market participants to clear all covered swaps entered into after the date the CFTC makes a mandatory clearing determination and that the obligation to clear would merely be delayed for the duration of the applicable phase-in period. This would have effectively compelled market participants to submit for clearing, by the end of the phase-in period, uncleared trades subject to a clearing mandate and entered into during the phase-in period. In response to these concerns, the CFTC clarified that market participants will only be required to clear covered swaps executed on and after their applicable compliance date to comply with the clearing requirement.

Phased-in Clearing Implementation Schedule

(i) Swaps between two "category 1 entities" will be subject to mandatory clearing no later than ninety (90) days after such clearing determination is published in the Federal Register. "Category 1 entities" include Regulated Entities and active funds (*i.e.*, any private fund that executes two hundred or more swaps (cleared or uncleared) based on a monthly average over the twelve months preceding the CFTC mandatory swap clearing determination).

(ii) Swaps between two "category 2 entities" or a category 2 entity and a category 1 entity will be subject to mandatory clearing no later than one hundred eighty (180) days after such clearing determination. "Category 2 entities" include commodity pools, private funds (other than active funds or third-party subaccounts), and other entities that are predominantly engaged in financial activities.

(iii) All other swaps will be subject to mandatory clearing no later than two hundred seventy (270) days after such clearing determination. This category includes swaps entered into by third-party subaccounts (managed accounts).

Clearing Documentation

End-users are not likely to directly access clearing by becoming members of one or more clearinghouses. Rather, most end-users will clear their trades through a clearing member (a futures commission merchant) and will need to negotiate clearing arrangements with one or more clearing members. The U.S. clearing documentation consists of a futures agreement, supplemented by an addendum addressing specific cleared derivatives issues and an

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execution agreement that mainly addresses the treatment of a transaction not accepted for clearing. Both the addendum and the execution agreement are based on forms published by the Futures Industry Association ("FIA") and ISDA. Both the futures agreement and the addendum are (sometimes heavily) negotiated by market participants to address a number of issues, such as guaranteed clearing, margining, portability and liquidation. Because the review and negotiation of a clearing arrangement may take some time, end-users should initiate the negotiation process in a timely manner so that they are fully operational by their applicable clearing compliance date.

Margin

In the spring of 2011, the CFTC and other U.S. banking regulators (prudential regulators) proposed regulations regarding margin and collateral posted in connection with uncleared swaps. The regulations would impose strict margin requirements and compel swap dealers to collect initial and variation margin from many counterparties that may not currently post any collateral. In addition, for uncleared swaps between Regulated Entities, the proposed rules would require all initial margin to be held by an independent third-party custodian. For all other uncleared swaps, including swaps between end-users and Regulated Entities, initial margin segregation would not be mandatory; Regulated Entities would only be required to offer their counterparty the option to have initial margin held in a segregated account with an independent third-party custodian. Any segregated margin would be subject to certain investment restrictions set forth in the Commodity Exchange Act.

Recognizing that a global approach was necessary to address these issues, an international working group was formed under the auspices of the Basel Committee on Banking Supervision and the International Organization of Securities Commission. The working group issued a consultation paper on July 6, 2012.[9] In light of these developments, the CFTC and prudential regulators re-opened the comment period for each of their proposed rules until September 14th and November 26th, respectively.

Anticipating regulatory requirements, many end-users are currently negotiating segregation arrangements with a third-party custodian. To aid market participants in putting segregation agreements in place, ISDA has published sample initial margin segregation terms and provisions that can be customized by counterparties.[10] In addition, an ISDA working group is currently drafting a form of tri-party segregation (collateral control) agreement to promote further standardization of these arrangements.

Industry Initiatives

In August 2012, ISDA published a protocol (the "Protocol"), which is essentially designed to bring market participants' trading relationships with their dealer counterparties in compliance with certain final rules promulgated by the CFTC under Dodd-Frank.

Unlike other ISDA protocols, the Protocol requires a more elaborate process for adherence because, in addition to executing an adherence letter, market participants will be required to complete a questionnaire and deliver that questionnaire to the swap dealer counterparties that they identify.

In the questionnaire, end-users must provide certain "know your counterparty" information for themselves and any applicable guarantor and third-party control person. The end-user's applicable status under Dodd-Frank (*i.e.*, eligible contract participant, commodity pool, special entity, etc.) will need to be specified, together with the end-user's LEI. For confidentiality reasons, the questionnaires will not be publicly disseminated like the adherence letter. Each end-user must receive a matching questionnaire from each of its swap dealer counterparties for the Protocol to be effective between the applicable parties to the covered swap agreements.

A party can submit the adherence letter through the ISDA website. Markit (in cooperation with ISDA) has developed a platform (ISDA Amend)[11] to automate the completion and bilateral delivery of questionnaires.

The operative provisions of the Protocol are set forth in a supplement containing representations, covenants and acknowledgements that the parties will activate in order to amend their existing swap agreements. Some of those provisions will only apply depending on the information provided and exchanged by the parties in the questionnaires. Also, parties may choose to activate specific parts of the schedule to establish the availability of certain safe harbors under Dodd-Frank (and the applicable swap dealer counterparty will need to do the same for the safe harbor to apply).

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Timing and Next Steps

Market participants should be aware that swap dealers will only be able to trade new swaps or enter into modifications of existing swaps with those counterparties that have adhered to the Protocol. While the CFTC has deferred the compliance date for many requirements of the external business conduct rules (which are among the provisions covered by the Protocol) until January 1, 2013, end-users should seek to implement the Protocol in a timely fashion to avoid trading disruptions.

Also, end-users should be aware that ISDA is planning a number of other protocols that will enable market participants to make the necessary amendments to their trading relationships so that they can comply with other aspects of Dodd-Frank once final implementing regulations have been adopted by regulators.

Conclusion

While end-users are not the main targets of the new derivatives regulations, their trading activities and business operations will nevertheless be directly impacted and end-users will need to take a number of actions to adjust to the new regulatory environment. Those actions include assessing whether they are subject to reporting obligations and, if so, implementing procedures to ensure compliance, negotiating clearing and collateral segregation arrangements, amending their trading facilities to ensure continued access to the derivatives market and implementing recordkeeping procedures. End-users should pay careful attention to compliance deadlines so that they can avoid any disruption to their trading activities. Also, they should understand how the rules will impact their funding needs, business operations, and relationship with trading counterparties and brokers.

Endnotes

1 *See* "Regulated Swap Entities Under Dodd-Frank", *Swiss Derivatives Review*, June 20, 2012.

2 Most issues addressed in this article relate to swaps subject to the CFTC's jurisdiction and do not generally relate to security-based swaps regulated by the Securities and Exchange Commission ("SEC") because the SEC has finalized fewer implementing regulations than the CFTC.

3 For purposes of this article we are not considering major swap participants to be end-users of swaps. Major swap participants are subject to many regulatory requirements under Dodd-Frank that do not apply to other end-users.

4 The compliance dates for swap data reporting for Regulated Entities begin as soon as they register with the CFTC: after October 12, 2012 for credit and interest rate swap transactions, and on January 10, 2013 for equity, foreign exchange, and other commodity swap transactions.

5 After one year of compliance, swap creation data reporting must be done within thirty-six business hours during the second year and twenty-four business hours thereafter.

6 After year one of compliance, swap continuation data reporting must be done within one business day.

7 Available at http://www.ciciutility.org.

8 Under the CFTC proposal, the following types of derivatives would be subject to the clearing requirement:
- Fixed-to-floating interest rate swaps, basis swaps, and forward rate agreements in U.S. dollars, the Euro, Pounds Sterling, or the Japanese Yen; and
- Untranched credit default swaps on certain North American indices (CDX.NA.IG and CDX.NA.HV) and European Indices (iTraxx Europe, iTraxx Europe Crossover, and iTraxx Europe HiVol).

9 Available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf.

10 Available at http://www2.isda.org/functional-areas/market-infrastructure/collateral/isda-sample-tri-party-ia-provisions/.

11 Available at http://www.markit.com/en/products/distribution/document-exchange/isda-amend.page. ■

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