

# ***FS Regulatory Brief***

## ***Is Your Counterparty Documented?***

### **ISDA Protocol adherence slower than expected**

December 2012

Swap dealers planning to register with regulators by year-end 2012 continue to face major challenges to meeting their duties to buy-side counterparties under the External Business Conduct (“EBC”) and Swap Trading Relationship Documentation (“Documentation”) rules adopted by the Commodity Futures Trading Commission (“CFTC”).<sup>1</sup> These rules require a swap dealer to vet each counterparty, update documentation, and deliver notices and disclosures to *each of its counterparties before each trade*. In other words, thousands of swap dealers’ accounts are affected. The buy-side meanwhile is being asked to identify and exchange documentation for each legal entity that will enter into a swap with a registered swap dealer, which is a particular challenge for investment managers with many advised funds and accounts under management.<sup>2</sup>

The industry has deployed a uniform solution to streamline efforts surrounding this challenging task. ISDA and Markit have teamed up to create a standardized, electronically managed documentation and disclosure solution called the ISDA DF Protocol (“ISDA Protocol” or “Protocol”). The Protocol provides a mechanism for swap dealers to exchange uniform questionnaires,

documentation, and disclosures with the buy-side more efficiently, and without need for bilateral negotiation.<sup>3</sup>

Given the thousands of counterparties to vet and remediate through the ISDA Protocol by year-end, many are wondering what the rate of uptake of the Protocol is and by what types of entities. This **FS Reg Brief** provides a snapshot of participation rates for the ISDA Protocol and information about the Protocol. It is offered as a guidepost for dealers and non-dealers toward meeting EBC and Documentation challenges.

It is important to note that during a House Financial Services Subcommittee Hearing on December 12<sup>th</sup>, CFTC Chairman Gary Gensler testified that the agency is considering granting swaps market participants additional time for EBC compliance beyond year-end. He indicated that ISDA had asked the CFTC to delay the rules for four months because of slow sign-up for the ISDA Protocol. Gensler also indicated that his agency will work with those entities operating in “good faith” to make the compliance process “as smooth as possible.”

Inclusion of these comments in Chairman Gensler’s testimony is a positive sign regarding the CFTC’s granting of no action relief. Nevertheless, institutions must press forward to meet the year-end deadline and at a minimum demonstrate “good faith.”

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<sup>1</sup> The CFTC adopted these rules to implement the swap market regulatory reforms contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

<sup>2</sup> Various factors such as the status of a counterparty as a US or non-US person and the planned booking location of the trade may reduce or change these requirements. Non-US persons addressing this challenge should seek guidance from their respective dealers.

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<sup>3</sup> The ISDA Protocol has been expanded to address other regulatory driven requirements affecting swap dealers and their counterparties.

## ***How does the ISDA Protocol work?***

The Protocol is a simplified method of addressing contractual amendments to ISDA documentation multilaterally and exchanging data by adding notices and representations prior to the execution of swap transactions. ISDA and Markit have developed an online tool for swap counterparties to submit completed questionnaires using ISDA Amend. The completion status of adherence letters is publicly available on the ISDA website (<http://www2.isda.org/functional-areas/protocol-management/protocol-adherence/8>).

Swap dealers and the buy-side each must adhere to the Protocol, which itself is a multi-step process that can require obtaining a uniform entity identifier. Once adherence is complete, each participant fills out a questionnaire that asks questions about the regulatory status of a counterparty and other factual information. It also permits a counterparty to elect to receive various “schedules” that relate to duties and representations provided under the EBC and Documentation rules.

Using the simplified ISDA Protocol itself requires effort. A swap dealer and each of its counterparties must *participate* in the ISDA Protocol in order to achieve an optimal compliance solution. Participation involves signing up (or “adhering”) to the Protocol, filling out a questionnaire and electing various representations or disclosures. In order to complete the ISDA Protocol process, a swap dealer must “match” with the counterparty via review of the questionnaire, elected schedules and other information.

However, matching is not as simple as it may appear. Swap Dealers are finding that manual review of matched counterparties is required before providing the “OK to trade.” Once validated, updates to various systems are also required to indicate how to treat each counterparty. This on-boarding process requires additional lead time and can lead to additional delays.

## ***Why is the ISDA Protocol helpful?***

The ISDA Protocol appears to be the most efficient means currently available for swap dealers to meet fast approaching deadlines on EBC and Documentation across their many counterparties and accounts. It also provides the buy-side with a single method for making the same information available to multiple swap dealers simultaneously.

## ***What is the regulatory deadline for compliance?***

Swap dealers that register by year-end must be in compliance with EBC duties by that registration date (unless temporary relief is granted). Phase-in dates will follow for the mandatory swap trading relationship documentation. ISDA has noted that, although the first compliance deadline for the EBC rules addressed by the Protocol is January 1, 2013, questionnaires should be submitted in advance of this date.

## ***How many entities have adhered to the Protocol?***

As of December 11, 2012, the ISDA website shows that 2,998 entities have adhered to the Protocol. This total includes various swap participants such as banks, investment managers, funds, corporations, and insurance companies, among others.

## Protocol Adherents by Industry (est. as of December 11):

Adherent Type	Adherents
Corporations	1,174
Funds	941
Investment managers	543
Banks	178
Insurance companies	78
Other	84
<b>Total*</b>	<b>2,998</b>

\* Source: <http://www2.isda.org/>

Although investment managers and various investment funds represent nearly half of the adhering parties, it is PwC's understanding from its bank clients that over 90% of swap counterparties have not yet submitted completed ISDA questionnaires permitting matching with swap dealers.

## Projections: What is our expectation by January 1, 2013?

At the rate of Protocol adherence to date, there will only be about 5,000 onboarded by year-end. However, the number of adherents is likely to increase significantly as the deadline arrives, as counterparties are taking a "wait-and-see" approach. They may have concerns with the Protocol but will likely sign up if other major market participants do. Therefore, expect a crowd on the eve of the deadline and be prepared for onboarding challenges due to stretched capacity.

## What should dealers do: To trade or not to trade?

### Preparing for Day 1 – Onboarding clients

In order to expedite Protocol uptake with counterparties, dealers should be reaching out to swaps participants. Relationship managers and sales teams should be mobilized and a multi-channel communication strategy should be implemented consisting of emails, both informational and educational, as well as phone calls to the counterparties explaining the Protocol and encouraging them to adhere. Additionally, in order to track compliance and industrialize readiness, dealers should consider automating the client tracking process to allow sales and traders to query counterparties to determine whether they have been matched in the system.

### Going Live – Sales & Trading in a Dodd-Frank world

Given the slow uptake of the Protocol and the need to continue trading after the compliance deadline, dealers may want to develop contingency plans. Recalling Hamlet's existential struggle, dealers face their own professional choice of whether "To trade or not to trade?"

*"Whether 'tis nobler in the mind to suffer the slings and arrows of outrageous fortune" by trading, or to "Take arms against a sea of troubles and by opposing them end them?" by halting trading with counterparties. That is the question.*

Dealers can prepare for this uncertainty by developing an approach to triage clients to either match via the Protocol or negotiate bi-laterally.

# Additional information

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