

Implementing Mandatory Clearing of Swaps Under the Dodd-Frank Act

OVERVIEW

Over-the-Counter Derivatives and Swaps—Dodd-Frank Title VII

The provision of the Dodd-Frank Act pertaining to Over-the-Counter (OTC) derivatives and swaps is designed to provide a framework for transparency and accountability given their volume and the intricate role they play in the financial markets. These changes will affect any investor trading in derivatives. Therefore, both active participants in the derivatives market, as well as less active investors, should understand how the new regulations will affect their trading activities. Below is a summary of the aspects of the Dodd-Frank Act—Title VII—pertaining to the mandatory clearing of swaps, services Northern Trust will provide, related integration costs, and onboarding timeline to support investment operations outsourcing clients.

NEW CLEARING REQUIREMENTS

The US Commodities Futures Trading Commission (CFTC) has issued final regulations, which establishes a schedule to phase in compliance with new clearing requirements. Under the new requirements, clearing will be phased in based on the type of market participant entering into swaps, subject to the clearing requirement. The compliance schedule identifies categories of market participants and provides a compliance timeframe for each as follows:

- **Category 1 Entities**
Includes swap dealers, security-based swap dealers, major swap participants, major security-based swap participants and active funds

Compliance Schedule: 90 days after publication in the Federal Register

- **Category 2 Entities**
Includes commodity pools; private funds (other than active funds); or entities predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, provided the entity is not a third-party subaccount

Compliance schedule: 180 days after publication in the Federal Register

- **Category 3 Entities**
All other entities, including those involving third-party subaccounts, ERISA plans and those not excepted from the clearing requirement

Compliance schedule: Within 270 days after publication in the Federal Register.

Swaps Subject to Mandatory Clearing in First Wave

Certain types of swaps will be subject to mandatory clearing in the first wave and will include:

- Interest Rate Swaps (fixed-to-floating rate swaps, basis swaps, overnight index swaps and forward rate agreements on certain common indices); and
- Credit Default Swaps on common indices

The CFTC has stated its intention to finalize all of its rules before the end of 2012.

TIMELINE FOR MANDATORY CLEARING OF SWAPS

The chart below reflects the timeline for mandatory clearing of swaps as the CFTC published final rules on mandatory clearing in the Federal Register:

November 28, 2012	CFTC publishes final clearing determination for swaps
March 11, 2013	Category 1 Entities to begin clearing swaps
June 10, 2013	Category 2 Entities to begin clearing swaps
September 09, 2013	Category 3 Entities to begin clearing swaps

Other Key Dates

- **December 31, 2012:** Earliest date for required registration for swap dealers and major swap participants and reporting and record-keeping requirements for interest rate and credit swaps
- **January 10, 2013:** Swap dealers and major swap participants reporting and recordkeeping
- **April 10, 2013:** End users subject to reporting and recordkeeping requirements for all swaps

HOW IS NORTHERN TRUST PREPARING?

Northern Trust has invested significantly in our capabilities to support post-trade operational functions for cleared swaps as follow:

- Implemented tools to support the new attributes of cleared swaps
- Connected downstream platforms (accounting, client reporting, valuations, margin management, etc.) to support cleared swaps
- Developed a link to route trades to a third party industry standard intermediary to have client trades formally confirmed and submitted to the exchange and clearing firms for acceptance
- Integrating statements from clearing brokers to support the daily margin requirements of cleared swaps
- Implementing a collateral management service to achieve margin optimization

WHAT DO CLIENTS NEED TO CONSIDER?

Understand and Prepare to Meet Mandatory Clearing Requirements

Investors need to understand their obligations under the final rules and determine what actions they will need to take based on the dates to be regulatory compliant. There are also steps you will need to take to be operationally compliant. If you currently transact, or plan to engage in OTC derivatives transactions, we encourage you to discuss your intentions with your Northern Trust relationship manager, including how you are preparing to meet the mandatory clearing requirements.

Post-Trade Activities for Clearing Swaps

Asset managers and outsource providers alike will continue to significantly invest in their derivative systems to support the new workflow required for mandatory clearing. This development has been a major area of focus for Northern Trust. We will continue to support asset managers in post-trade operational activities for clearing swaps.

Development and Testing Period

Each client's trading activities are unique and will require specific trade feeds, reporting requirements, clearing broker connectivity, etc. As such, each will require small amounts of development and testing. The lead-time required to effectively on-board a client onto the new clearing platform is several months. As this is a significant change to the derivatives industry and the services to support this activity, an implementation charge will apply. In general, the one-time implementation fee will account for the following:

- Trade file changes to include new attributes specific to cleared swaps
- Mapping client file to meet MarkitSERV requirements
- Client reporting adjustments
- Testing between Northern Trust, clearing broker, MarkitSERV, exchange (potentially), and client

Following implementation, normal transaction processing, position maintenance, and margin movement fees will apply as they do to support bilateral swaps.