AUGUST, 2013

ARE YOU READY? NEW SWAP TRADING REQUIREMENTS FOR PENSION PLAN ASSET MANAGERS

ASSET MANAGER TO DO LIST:

The Dodd-Frank Act and its implementing regulations bring significant new regulatory oversight to the over-the-counter (OTC) derivatives markets. As the markets respond, the menu of derivatives instruments available to asset managers, and the costs associated with those instruments, will change significantly. As the first new swap rules have come into effect earlier this year, market participants have started to identify risks and costs, as well as opportunities, arising from this new regulatory landscape.

For US pension plans and separately managed accounts, mandatory swap clearing for certain interest rate swaps (IRS) and credit default swaps (CDS) is required by September 9, 2013. This memorandum highlights some of the steps that affected asset managers must take to prepare for clearing and other regulatory requirements.

As the markets respond to OTC swap-market regulatory reforms in the United States, Europe and Asia, asset managers and other market participants must take stock of how the developments affect them and assess their readiness for the new regimes.

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CLASSIFY THE FINANCIAL INSTRUMENTS YOU TRADE

DETERMINE WHETHER THE FINANCIAL INSTRUMENTS YOU TRADE FALL WITHIN THE CLASSES OF SWAPS THAT THE CFTC REQUIRES TO BE CLEARED.

The new Dodd-Frank derivatives regulatory requirements apply to derivatives instruments known as "swaps," "security-based swaps" and "mixed swaps." "Swaps" are subject to the primary jurisdiction of the Commodity Futures Trading Commission (CFTC). "Security-based swaps" are subject to the primary jurisdiction of the Securities and Exchange Commission (SEC). Instruments that materially reference both swap and security-based swap underliers are known as "mixed swaps" and are subject to the joint jurisdiction of the CFTC and SEC. You must determine whether the financial instruments you trade fall within one of these classes.

Only CFTC-regulated swaps, and, to a more limited extent, deliverable foreign-exchange forwards and swaps, are currently subject to the requirements described in this memorandum at this time.

DETERMINE US PERSON STATUS OF THE PENSION FUNDS YOU MANAGE

CFTC SWAP REGULATIONS APPLY TO TRADES BETWEEN TWO US PERSONS AND MAY APPLY TO OTHER PERSONS

In addition to determining whether the financial instruments you trade are subject to the new regulatory regime, you must determine the extent to which the regulations apply to the pension plan for which you trade and to the counterparties with whom you trade. In general, the US swap regulatory regime applies to any swap between US persons and does not apply to a swap between two non-US persons that have no nexus to the United States. However, the applicability of US swap regulations to situations that fall between these two extremes is more complex.

The CFTC recently adopted interpretive guidance (the Guidance) that describes the application of its swap-related requirements to swaps in which one or more counterparties is not a "US person." The rules may apply somewhat differently depending on, among other factors:

- a person's (including a pension plan's) status under the complex "US person" definition in the Guidance;
- its counterparty's "US person" and registration status, guarantee structure and location from which it trades;
- whether the jurisdiction in which the transaction takes place has been deemed to have "comparable" law by the CFTC; and
- the specific requirement in question.

The Guidance is subject to a limited phase-in period that, for certain counterparties with respect to certain requirements, provides relief until dates between September and December 2013.

In general, if a pension plan is a US person, or if a pension plan transacts with a US office of a US swap dealer, all swap-related requirements will apply. However, a pension plan that is not a US person may face fewer requirements when transacting with a non-US swap dealer, or with a non-US branch of a US swap dealer, than when facing the US home office of a US swap dealer. As a result, it is important to determine whether the pension plans you advise are US persons and, if not, whether changes in your trading structure may be beneficial.

PREPARE FOR OR COMMENCE CLEARING SPECIFIED IRS AND CDS BEFORE SEPTEMBER 9TH DEADLINE

The Dodd-Frank Act requires that market participants clear standardized swaps through clearinghouses. Clearing requirements are being phased in according to type of financial instrument and according to the type of market participants that are parties to the swap. The first clearing requirement applies to certain IRS and CDS. Mandatory clearing began on March 11, 2013 for swap dealers, major swap participants (MSPs) and the most-active private funds, included financial entities (excluding ERISA plans and third-party subaccounts) as of June 10, 2013 and will include ERISA plans, third-party subaccounts and non-financial entities ("Category 3" entities) as of September 9, 2013, though ERISA plans that are not US persons may have more time in certain cases. While September 9, 2013 may be seen as the first day of mandatory clearing for Category 3 asset managers, it is perhaps better thought of as the deadline beyond which uncleared trading of the specified instruments will no longer be permitted absent an available exemption. Early adoption of clearing through clearinghouses is possible and may be advantageous.

When applied to your swaps, clearing may have a significant impact on cost and trade mechanics. In order to directly submit a swap for clearing at a clearinghouse, a market participant must be a member of that clearinghouse. Clearing members, who generally must be registered with the CFTC as futures commission merchants (FCMs), are generally banks and other financial institutions with the largest swap businesses. As a result, you will likely need to make arrangements with one or more clearing members in order to clear swaps for the pension plans you manage. Market participants often contract for clearing services from more than one FCM so that, if the primary FCM fails, positions can be "ported" to another clearing member of the clearinghouse instead of becoming subject to an unwind process. When you are selecting your FCMs, you may wish to choose several financially strong providers to ensure continuity of service in the event that one FCM should experience financial difficulties.

At a high level, the swap clearing relationship between a customer and an FCM clearing member is based on two primary documents: a base Futures and Options Agreement and an OTC Clearing Addendum. Many market participants also enter into a Cleared Derivatives Execution Agreement with potential executing counterparties to govern the treatment of a swap that is intended to be cleared but is not. The OTC Clearing Addendum and Cleared Derivatives Execution Agreement may each contain a number of representations specific to ERISA plans and their managers.

When you are a counterparty to a cleared swap, you will be required to post initial margin (independent amounts) and pay variation margin (mark-to-market amounts) on cleared swaps to your clearing member, who will post some or all of that margin to the clearinghouse. The amount of initial margin required for cleared swap transactions is calculated by the clearinghouse based on internal models; however, FCM clearing members may also require you to post collateral in excess of the amounts required by the clearinghouse. For this reason also, you may wish to negotiate clearing arrangements with more than one FCM, as the amount of initial margin that an FCM may require in excess of the clearinghouse minimum may be a significant factor in the cost of cleared swaps. Your collateral posted to satisfy initial margin requirements for cleared swaps will be held at the clearinghouse in accordance with the CFTC's "legally segregated, operationally commingled," or "LSOC," rule, which aims to protect non-defaulting customers of a clearing member from losses incurred by defaulting customers of the same clearing member. The LSOC rule also provides for the possibility of customer collateral being held in an independent custody account.

DEFINITION OF "US PERSON"
Under the Guidance, the term "US person" generally includes, but is not limited to:

(i) any natural person who is a resident of the United States;

(ii) any estate of a decedent who was a resident of the United States at the time of death;

(iii) any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing (other than an entity described in prongs (iv) or (v), below) (a "legal entity"), in each case that is organized or incorporated under the laws of a state or other jurisdiction in the United States or having its principal place of business in the United States;

(iv) any pension plan for the employees, officers or principals of a legal entity described in prong (iii), unless the pension plan is primarily for foreign employees of such entity;

(v) any trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust;

(vi) any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described in prong (iii) and that is majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v), except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to non-US persons and not offered to US persons;

(vii) any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v) and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity; and

(viii) any individual account or joint account (discretionary or not)where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in prong (i), (ii), (iii), (iv), (v), (vi), or (vii).

Although some swaps will continue to be transacted bilaterally without being cleared—for example, where a swap is not required to be cleared (and the counterparties do not choose to clear it) or where the counterparties rely on a clearing exception—uncleared swaps will generally be subject to initial- and variation-margin requirements, with floors set by regulation. Under current proposals, the amount of initial margin required for uncleared swaps would generally exceed that required for cleared swaps, making uncleared swaps relatively expensive and promoting the use of standardized, clearable instruments.

CHOOSE FINANCIALLY STRONG FCMS WHEN YOU SELECT YOUR CLEARING FCMS – THESE TYPES OF FIRMS MAY BE AFFILIATED WITH BANKS OR OTHER MAJOR FINANCIAL INSTITUTIONS.

Uncleared-swap margin requirements will represent a dramatic change from current practice. You will need to decide whether a transaction's goals are better served by using bespoke swaps, which may better achieve specific goals but at a higher margin cost, or by using standardized swaps that will be less costly but require new intermediary relationships and may not match your goals for the transaction perfectly.

The chart below describes by counterparty type the general principles for compliance-date timing and the specific compliance dates for IRS and CDS for which the CFTC has already made a clearing determination.

Counterparties	General Compliance Date	General Compliance Date for IRS and CDS
Swaps between two Category 1 entities Category 1 Entities include swap dealers, MSPs and "active funds." An "active fund" is any private fund, other than a third-party subaccount, that executes 200 or more swaps per month based on a monthly average over the preceding 12 months, beginning on November 1, 2012.	90 days after a final CFTC clearing determination	March 11, 2013 (April 26, 2013 for iTraxx CDS)
Swaps between a Category 1 entity and a Category 2 entity, or between two Category 1 entities "Category 2" entities include commodity pools, private funds (other than active funds) and persons predominantly engaged in banking or financial activities, as well as asset managers, registered investment companies and pooled investment vehicles other than ERISA plans and positions managed through a separate account arrangement that qualifies as a "third-party subaccount". A "third-party subaccount" is a client account managed by an unaffiliated and independent asset manager where the asset manager is responsible for the documentation necessary for the account owner to clear swaps.	180 days after a final CFTC clearing determination	June 10, 2013 (July 25, 2013 for iTraxx CDS)
Inclusion of ERISA plans and other Category 3 entities Includes swaps where one counterparty is an ERISA plan, a non-financial end user or a "third-party subaccount."	270 days after a final clearing determination	September 9, 2013 (October 23, 2013 for iTraxx CDS)

The CFTC has published specifications for five swap classes that pension-plan asset managers and other Category 3 entities are required to begin clearing no later than September 9, 2013 and for iTraxx CDS indices on European corporate names that they are required to begin clearing on October 23, 2013. Below is an overview of the specifications of the swap classes subject to mandatory clearing.

CDS

The credit defaut swaps that have been designated as subject to mandatory clearing are divided into two classes:

- The first class is based on the untranched indices covering North American corporate credits, the CDX North American Investment Grade (CDX.NA.IG) and the CDX North American High Yield (CDX.NA.HY).
- The second class is based on the untranched indices covering European corporate credits, iTraxx Europe, iTraxx Europe Crossover and iTraxx Europe High Volatility.

THE CFTC HAS PUBLISHED SPECIFICATIONS FOR THE FIRST CLASSES OF SWAPS THAT MUST BE CLEARED.

IRS

The interest rate swaps that have been designated as subject to mandatory clearing include the following instruments in US dollars, euros, British pounds and (other than for overnight indexed swaps) Japanese yen:

- "Fixed-to-floating swap". A swap in which the payment or payments owed for one leg of the swap is calculated using a fixed rate and the payment or payments owed for the other leg are calculated using a floating rate.
- "Floating-to-floating swap" or "basis swap". A swap in which the payments for both legs are calculated using floating rates.
- "Forward Rate Agreement" or "FRA". A swap in which payments are exchanged on a pre-determined date for a single specified period, and one leg of the swap is calculated using a fixed rate and the other leg is calculated using a floating rate that is set on a predetermined date.
- "Overnight indexed swap" or "OIS". A swap for which one leg of the swap is calculated using a fixed rate and the other leg is calculated using a floating rate based on a daily overnight rate.

CONFIRM THAT THE PENSION FUNDS YOU MANAGE ADHERE TO ISDA PROTOCOLS

A number of Dodd-Frank requirements that are not directly applicable to asset managers will require you to amend or enter into new documentation. The CFTC's "external business conduct" rules govern the relationship between a swap dealer and any non-swap dealer counterparty with whom it enters into a swap, offers to enter into a swap, recommends a swap or advises on swap trading strategies. At a high level, they require a swap dealer to verify counterparty eligibility, disclose key information about the swap and the swap dealer and establish suitability and other sales practice standards. Swap dealers owe heightened duties to special entity counterparties—which include ERISA plans, municipalities and endowments. Asset managers that advise non-ERISA special entities may need to serve as an independent representative. Other CFTC rules also require swap dealers to have relationship documentation and cover the exchange of information between swap dealer and counterparty through acknowledgments and confirmations.

DODD-FRANK REQUIRES ASSET MANAGERS TO AMEND OR ENTER INTO NEW DOCUMENTATION.

As a practical matter, swap dealers need a mechanism to comply with these rules and will need their counterparties to provide them with representations to meet many of the requirements. If you are an in-house asset manager for transactions subject to the CFTC's rules, to avoid disruptions in trading, you will need to provide swap dealers with the information and representations they need. If you are an outside asset manager engaging in such transactions on behalf of a pension plan, your client may expect you to educate them about the requests they are receiving and help them provide swap dealers with the information they need. Depending on your arrangements with your clients, on their behalf, you may provide the required representations to and receive information from swap dealers.

The ISDA Dodd-Frank Protocol is an industry effort to satisfy Dodd-Frank Act requirements through a series of multilateral adherence processes which allows for various standardized amendments to be made to the relevant agreements between any two adhering parties. ISDA intends to release a series of Protocols to facilitate compliance with new swap regulatory requirements as they are adopted and become effective. The first Protocol, known as the August 2012 Dodd-Frank Protocol (or Protocol 1.0), is primarily designed to address the external business conduct rules. The second Protocol, known as the March 2013 Dodd-Frank Protocol (or Protocol 2.0), is primarily designed to address the swap trading relationship documentation and related rules. Both Protocols can currently be accessed via the ISDA Amend website.

CONSIDER IMPLICATIONS OF REPORTING REQUIREMENTS AND OF PUBLIC ACCESS TO SWAP TRANSACTION DATA

To increase swap-market transparency, the Dodd-Frank Act established a reporting regime under which the reporting counterparty to a swap must report information about that swap to a swap data repository (SDR). As long as the asset manager has a swap-dealer counterparty, the swap dealer will be the "reporting counterparty" with primary responsibility for reporting the swap. However, the asset manager will have some residual obligations, including obtaining a legal entity identifier for itself and the pension plans it manages, reporting ultimate allocations to the swap dealer within specified timelines, notifying the swap dealer of any errors or omissions in reported data of which it becomes aware and keeping complete and systematic records of swaps.

SDRS WILL PUBLICLY DISSEMINATE ROUNDED NOTIONAL AMOUNTS, UNDERLYING ASSETS, YIELDS, SPREADS, COUPONS AND PREMIUMS.

Some information is publicly disseminated by the SDR in real time, while other information is only available to regulators. The public reporting of pricing and transaction data for swaps is likely to present you with more visibility into market trends and conditions in the swaps you trade for your pension plans. However, more information also leads to concerns about ensuring anonymity of trades.

SDRs must publicly disseminate transaction and pricing data immediately upon receipt from the reporting counterparty. The information that SDRs publicly disseminate includes the rounded notional amount of the swap, the underlying assets for a swap and information necessary to evaluate the price of the swap, including the yield, spread, coupon, premiums and other pricing terms. Critically, however, the identities of the counterparties and certain other information reported to the SDR, is not publicly disseminated and the CFTC has established regulatory safeguards to protect swap counterparty anonymity in illiquid markets, where the identity of a counterparty might be inferred based on trading behavior. If a trade is large enough to qualify as a "block trade," the SDR will delay public dissemination of the transaction data.

PREPARE FOR MANDATORY EXCHANGE TRADING OF MANDATORY CLEARED SWAPS

Once any designated contract market (DCM) or swap execution facility (SEF) makes a swap that is subject to mandatory clearing "available to trade," any trade in that instrument must be executed on a DCM or on a SEF. DCMs and SEFs may begin to make some mandatory cleared swaps available to trade as early as December 2013.

It is not yet clear what portion of the swap market will be subject to this requirement. For the most liquid swaps, this change will represent a major departure from traditional bilateral negotiation and execution of swaps.

Once mandatory trading on SEFs begins, CFTC rules require that SEF transactions subject to the mandatory trade-execution requirement be executed through an order book or a request-for-quote (RFQ) system. The RFQ system requires each market participant, including asset managers, to request a quote from at least three market participants on the SEF, or two during a one-year phase-in period. This requirement precludes bilaterally negotiating transactions and then executing them on a SEF. Other trades, including swaps not subject to mandatory clearing and block trades, may be pre-arranged and executed through an order book, RFQ system, a voice-based system or any other CFTC-permitted trading system.

WHEN SWAPS SUBJECT TO MANDATORY CLEARING BECOME AVAILABLE TO TRADE, TRADES IN THOSE INSTRUMENTS MUST TAKE PLACE ON A DCM OR SEF.

REVIEW PREPARATIONS WITH YOUR TRADING, CLEARING AND CUSTODY PARTNERS AND ADVISORS

Swap regulatory reform efforts are underway worldwide and this memorandum has highlighted some of the major steps that pension plan and other asset managers must take in the United States in order to prepare for the new regulatory regime under the Dodd-Frank Act. In particular, September 9, 2013 is an important deadline because ERISA plans and other Category 3 entities that are US persons must commence clearing for certain IRS and CDS by that date, and non-US ERISA plans may need to commence clearing shortly thereafter for the same types of swaps with certain counterparties. To be prepared, prior to the deadline you will want to have taken steps such as classifying the financial instruments you trade, selecting clearing FCMs and entering into necessary relationship documentation.

As you make your preparations, you should review them with your trading, clearing and custody partners and advisors, most of whom will have experience with the new regulatory regime in the United States because they are already subject to the CFTC's mandatory clearing requirements.

When September 9, 2013 arrives, be ready.

TAKE ADVANTAGE OF YOUR TRADING AND CLEARING PARTNERS AND ADVISORS' DODD-FRANK EXPERIENCE AND INSIGHTS.

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08/2013

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