

## Expert Analysis

### The CFTC's Final Rules Regarding Swap Documentation

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On Aug. 27 the Commodity Futures Trading Commission approved final rules under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act relating to swap documentation. The final rules, titled "Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants," were published in the Federal Register Sept. 11.<sup>1</sup> The final rules are based on proposed rules that the CFTC released in somewhat different form in February 2011.

The final rules require swap dealers and major swap participants<sup>2</sup> to undertake risk-reducing practices relating to documentation. Because cleared swaps are exempted from many requirements, the final rules seem likely to help push the market toward centrally cleared transactions. The effective date for the final rules will generally be 60 days after their publication in the Federal Register, or Nov. 12.<sup>3</sup>

#### SWAP CONFIRMATIONS (SECTION 23.501)

Subject to a complex compliance schedule, which is set out in the chart below, in 17 C.F.R. § 23.501, the CFTC requires swap dealers and major swap participants to limit the time between the execution of a swap transaction (that is, the time at which the parties agree to the terms of a transaction in a legally binding manner) and the time at which an SD or MSP sends out or signs legally binding documentation as to the terms of such transaction.

The terminology used in 17 C.F.R. § 23.501 is somewhat confusing. The CFTC rejected comments with regard to its definition of "acknowledgment,"<sup>4</sup> and under the final rules an "acknowledgment" (defined as "a written or electronic record of all of the terms of a swap signed and sent by one counterparty to the other") is difficult to distinguish from a confirmation signed by one party.<sup>5</sup>

Further, the final rules define "confirmation" not in its usual sense, as a paper or electronic representation, intended to be legally binding, as to the terms of a particular swap transaction, but instead as the *consummation* of legally binding documentation of such terms.<sup>6</sup> The regulations generally appear to use the term "confirmation," however, in its usual sense.

Subject to the compliance schedule set out below:

- Each SD and MSP entering into a swap transaction with an SD or MSP is required to execute a confirmation for such swap transaction as soon as technologically practicable, and no later than the end of the first business day following the day of execution of the transaction.
- Each SD and MSP entering into a swap transaction with a counterparty that is not an SD or MSP is required to send an acknowledgment of such swap transaction as soon as technologically practicable, and no later than the end of the first business day following the day of execution of the transaction.<sup>7</sup>

In addition, SDs and MSPs are required to establish and follow written policies and procedures reasonably designed to ensure:

- That it executes a confirmation for each swap transaction that it enters into with a financial entity<sup>8</sup> as soon as technologically practicable, but no later than the end of the first business day following the day of execution.
- That it executes a confirmation for each swap transaction that it enters into with a counterparty that is not an SD, MSP or financial entity no later than the end of the second business day following the day of execution.<sup>9</sup>

The procedures required under 17 C.F.R. §§ 23.501(a)(3)(i) and (ii), provide that, upon a request by a prospective counterparty prior to execution of any such swap, the SD or MSP will furnish to the prospective counterparty prior to execution a draft acknowledgment specifying all terms of the swap transaction (other than pricing and other terms to be agreed at execution).<sup>10</sup> SDs and MSPs are required to make and retain a record of the date and time of transmission to, or receipt from, a counterparty of any acknowledgment or confirmation.<sup>11</sup>

A failure to adhere to the rules for swap confirmation will not affect the enforceability of the related transaction.<sup>12</sup>

#### ***Compliance schedule***

The compliance schedule for executing confirmations and acknowledgments is set out in the chart on P. 3.

#### ***Transactions deemed to satisfy § 23.501***

The final rules provide that, subject to certain conditions, swaps executed on swap execution facilities or designated contract markets, or submitted for clearing, will be deemed to satisfy the requirements of 17 C.F.R. § 23.501.

If the rules of a swap execution facility or designated contract market make clear that confirmation of all terms of the transaction takes place at the same time as the execution of a swap, any swap that is executed on that swap execution facility or designated contract market will be deemed to satisfy the requirements of Section 23.501.<sup>13</sup>

Further, any swap that is submitted for clearing by a derivatives clearing organization will satisfy the requirements of Section 23.501, provided that:

- The swap transaction is submitted for clearing as soon as technologically practicable, but in any event no later than the times established for confirmation under Section 23.501.

Action	Counterparties	Type of Swap	Phase-in Timeline for Execution of Confirmation or Sending Acknowledgment
Execute confirmation (§ 23.501(a)(1))	SD or MSP facing SD or MSP	Credit swap or interest rate swap	By the end of the second business day following the day of execution from the effective date to Feb. 28, 2014, and the end of the first business day following the day of execution thereafter
Execute confirmation (§ 23.501(a)(1))	SD or MSP facing SD or MSP	Equity swap, foreign exchange swap or other commodity swap	By (i) the end of the third business day following the day of execution for the period from the effective date to Aug. 31, 2013; (ii) the end of the second business day following the day of execution for the period from Sept. 1, 2013, to Aug. 31, 2014; and (iii) the end of the first business day following the day of execution thereafter
Send acknowledgment (§ 23.501(a)(2))	SD or MSP facing counterparty that is neither SD nor MSP	Credit swap or interest rate swap	By (i) the end of the second business day following the day of execution for the period from the effective date to Feb. 28, 2014, and (ii) the end of the first business day following the day of execution thereafter
Send acknowledgment (§ 23.501(a)(2))	SD or MSP facing counterparty that is neither SD nor MSP	Equity swap, foreign exchange swap or other commodity swap	By (i) the end of the third business day following the day of execution for the period from the effective date to Aug. 31, 2013; (ii) the end of the second business day following the day of execution for the period from Sept. 1, 2013, to Aug. 31, 2014; and (iii) the end of the first business day following the day of execution thereafter
Establish, maintain and follow written policies and procedures designed to ensure it executes confirmations with financial entities within the time frames provided (§ 23.501(a)(3)(i))	SD or MSP facing a financial entity	Credit swap or interest rate swap	By (i) the end of the second business day following the day of execution for the period from the effective date to Feb. 28, 2014, and (ii) the end of the first business day following the day of execution thereafter
Establish, maintain and follow written policies and procedures designed to ensure it executes confirmations with financial entities within the time frames provided (§ 23.501(a)(3)(i))	SD or MSP facing a financial entity	Equity swap, foreign exchange swap or other commodity swap	By (i) the end of the third business day following the day of execution for the period from the effective date to Aug. 31, 2013; (ii) the end of the second business day following the day of execution for the period from Sept. 1, 2013, to Aug. 31, 2014; and (iii) the end of the first business day following the day of execution thereafter
Establish, maintain and follow written policies and procedures designed to ensure it executes confirmations within the time frames provided (§ 23.501(a)(3)(ii))	SD or MSP facing a counterparty that is not an SD, MSP or financial entity	Credit swap or interest rate swap	Not later than (i) the end of the fifth business day following the day of execution for the period from the effective date to Aug. 31, 2013; (ii) the end of the third business day following the day of execution for the period from Sept. 1, 2013, to Aug. 31, 2014; and (iii) the end of the second business day following the day of execution thereafter
Establish, maintain and follow written policies and procedures designed to ensure it executes confirmations within the time frames provided (§ 23.501(a)(3)(ii))	SD or MSP facing a counterparty that is not an SD, MSP or financial entity	Equity swap, foreign exchange swap or other commodity swap	Not later than (i) the end of the seventh business day following the day of execution for the period from the effective date to Aug. 31, 2013; (ii) the end of the fourth business day following the day of execution for the period from Sept. 1, 2013, to Aug. 31, 2014; and (iii) the end of the second business day following the day of execution thereafter

- Confirmation of all terms of the transaction takes place at the same time the swap transaction is accepted for clearing pursuant to the rules of the derivatives clearing organization.<sup>14</sup>

If an SD or MSP is notified that a particular swap transaction has not been confirmed by a swap execution facility or designated contract market, or accepted for clearing by a derivatives clearing organization, then the SD or MSP must execute a confirmation for such swap transaction as soon as technologically practicable, but in any event no later than the times established for confirmation, as if such swap transaction were executed at the time the SD or MSP receives such notice.<sup>15</sup>

### PORTFOLIO RECONCILIATION (SECTION 23.502)

The CFTC's rules regarding portfolio reconciliation require swap dealers and others to reconcile their swap portfolios with their counterparties. Reconciliation is defined to include the parties to a portfolio of swaps both:

- Exchanging the values they attribute to such swaps and the terms of such swaps.
- Resolving any material discrepancy.<sup>16</sup>

Accordingly, this rule is calculated to require that SDs and MSPs resolve any material discrepancies as to swap terms or values. The portfolio reconciliation rule does not apply to swaps that are cleared by a derivatives clearing organization.<sup>17</sup>

#### *Swaps involving only SD and MSPs*

##### Required reconciliations

As to swaps to which each counterparty is either an SD or an MSP, the counterparties are required to "agree in writing with each of its counterparties" as to the terms of reconciliations and to perform portfolio reconciliations (either directly or by means of a qualified third party) at frequencies that depend upon the number of transactions between the parties.<sup>18</sup> Specifically, they are required to undertake portfolio reconciliations at least:

- Daily on each business day for each swap portfolio including 500 or more swaps.
- Weekly for each swap portfolio including more than 50 but fewer than 500 swaps.
- Quarterly for each swap portfolio including no more than 50 swaps.

The highest number of swaps in a relevant week determines whether a weekly or quarterly reconciliation is required.<sup>19</sup>

##### Resolution of discrepancies

SDs and MSPs are required to "resolve immediately any discrepancy in a material term of a swap identified as part of a portfolio reconciliation or otherwise."<sup>20</sup>

In addition, SDs and MSPs are required to establish and follow written policies and procedures designed to both resolve valuation discrepancies "as soon as possible, but in any event within five business days," and to state how the SD or MSP will comply with applicable variation margin requirements prior to the resolution of the valuation discrepancy.<sup>21</sup> A difference in valuation "need not be deemed a discrepancy" if it is equal to less than 10 percent of the higher valuation.<sup>22</sup>

*A failure to adhere to the rules for swap confirmation will not affect the enforceability of the related transaction.*

### **Swaps with counterparties that are neither SDs nor MSPs**

Each SD and MSP is to establish and follow written policies and procedures reasonably designed to ensure that it engages in portfolio reconciliations for all swaps in which its counterparty is not an SD or an MSP. As to such swaps, the SD or MSP must “agree in writing” with each counterparty as to the terms of portfolio reconciliations, including as to any third-party service provider.<sup>23</sup>

The SD’s or MSP’s policies and procedures are required to provide for portfolio reconciliations at frequencies that depend upon the number of transactions between the parties. Specifically, the policies and procedures must provide for portfolio reconciliations no less than:

- Quarterly for each swap portfolio including more than 100 swaps.
- Annually for each swap portfolio including no more than 100 swaps.

The highest number of swaps in the relevant quarter determines whether a quarterly or annual reconciliation is required.<sup>24</sup>

In connection with swaps with counterparties that are not SDs or MSPs, SDs and MSPs are required to establish and follow written procedures designed to resolve any discrepancies as to material terms or valuation of each swap “in a timely fashion.”<sup>25</sup> A difference in valuation “need not be deemed a discrepancy” if it is equal to less than 10 percent of the higher valuation.<sup>26</sup>

### **Reporting**

Each SD and MSP is required promptly to report to the CFTC and any applicable prudential regulator (and, with regard to security-based swaps, to the Securities and Exchange Commission) any swap valuation dispute in excess of \$20 million if the dispute is not resolved within:

- Three business days, if the dispute is with a counterparty that is an SD or MSP; or
- Five business days, if the dispute is with a counterparty that is not an SD or MSP.<sup>27</sup>

### **PORTFOLIO COMPRESSION (SECTION 23.503)**

The final rules require SDs and MSPs to establish and follow written policies and procedures in relation to offsetting swaps and portfolio compressions, under which counterparties “compress” their swap portfolios into portfolios with a reduced aggregate notional amount (or other measure of risk).<sup>28</sup> This rule does not apply to any swap that is cleared by a derivatives clearing organization.<sup>29</sup>

### **Portfolio compression with SDs and MSPs**

Each SD and MSP is required to establish and follow written policies and procedures for:

- Terminating in a timely manner, when appropriate, each fully offsetting swap with a counterparty that is also an SD or MSP.
- Periodically engaging in bilateral portfolio compression exercises, when appropriate, with each counterparty that is also an SD or MSP.
- Periodically engaging in multilateral portfolio compression exercises, when appropriate, with each counterparty that is also an SD or MSP.<sup>30</sup>

***The portfolio reconciliation rule does not apply to swaps that are cleared by a derivatives clearing organization.***

*Each swap dealer and major swap participant is required to have periodic audits, conducted by an independent internal or external auditor, that are sufficient to identify any material weakness in its documentation policies and procedures.*

The policies and procedures in relation to multilateral portfolio compression exercises are required to address:

- Participation in all multilateral portfolio compression exercises required by the CFTC.
- Evaluation of multilateral portfolio compression exercises that are initiated, offered, or sponsored by any third party.<sup>31</sup>

#### ***Portfolio compression with counterparties that are neither SDs nor MSPs***

Each SD and MSP is required to establish and follow “written policies and procedures for periodically terminating fully offsetting swaps and for engaging in portfolio compression exercises” relating to swaps in which the counterparty is neither an SD nor an MSP “to the extent requested by any such counterparty.”<sup>32</sup>

### **SWAP TRADING RELATIONSHIP DOCUMENTATION (SECTION 23.504)**

#### ***Applicability***

The rules for swap trading relationship documentation set out in 17 C.F.R. § 23.504 do not apply to:

- Swaps cleared by a derivatives clearing organization.
- Swaps executed on a designated contract market or executed anonymously on a swap execution facility, provided that such swaps are cleared by a derivatives clearing organization and all terms of the swaps conform to the rules of the derivatives clearing organization and certain of CFTC regulations.<sup>33</sup>
- Swaps executed prior to the date on which an SD or MSP is required to be in compliance.<sup>34</sup>

#### ***Policies and procedures***

Each SD and MSP is required to establish and follow written policies and procedures reasonably designed to ensure that the SD or MSP executes written swap trading relationship documentation with its counterparty that complies with the requirements of 17 C.F.R. § 23.504. Other than confirmations of swap transactions (which may be executed after the execution of the related swap), the swap trading documentation must be executed “prior to or contemporaneously with” entering into a swap transaction with any counterparty.<sup>35</sup>

#### ***Required documentation***

Swap trading relationship documentation must be in writing and must include all terms governing the trading relationship between the SD or MSP and its counterparty, including, without limitation, terms addressing:

- Payment obligations.
- Netting of payments.
- Events of default.
- Other termination events.
- Calculation and netting of obligations upon termination.

- Transfer of rights and obligations.
- Governing law.
- Valuation.
- Dispute resolution.<sup>36</sup>

The swap trading relationship documentation is to include credit support arrangements, which must contain the terms required under CFTC regulations (not yet finalized)<sup>37</sup> or under regulations to be issued by prudential regulators.<sup>38</sup>

### **Valuation**

The swap trading relationship documentation between SDs, between MSPs, between an SD and MSP, between an SD or MSP and a financial entity, and, if requested by any other counterparty, between an SD or MSP and such counterparty, must include written documentation in which the parties agree on the process for determining the value of each swap at any time for purposes of complying with relevant margin or risk management requirements. The documentation may include any agreed-upon methods, procedures, rules, and inputs, but to the maximum extent practicable, the valuation of each swap is to be based on objective criteria such as recently executed transactions or valuations provided by independent third parties.<sup>39</sup>

Swap trading relationship documentation must also include either:

- Alternative methods for determining the value of the swap in the event of the unavailability or other failure of any input required to value the swap.
- A valuation dispute resolution process.<sup>40</sup>

An SD or MSP is not required to disclose to the counterparty confidential, proprietary information about any swap valuation model it may use.<sup>41</sup>

### **Other required provisions**

Swap trading relationship documentation must state whether either party is a financial company (as defined in Section 201(a)(11) of Dodd-Frank) or an insured depository institution (as defined in 12 U.S.C. § 1813), and must give notice that in certain circumstances, limitations under Title II of Dodd-Frank or the Federal Deposit Insurance Act may apply to the right to terminate, liquidate or net a swap with such a counterparty.<sup>42</sup>

In addition, swap trading documentation of each SD and MSP is required to state that, upon acceptance of a swap by a derivatives clearing organization, the original swap is extinguished and replaced by equal and opposite swaps with the derivatives clearing organization, and all terms of the swap shall conform to the product specifications of the cleared swap established under the rules of the relevant derivatives clearing organization.<sup>43</sup>

### **Audit requirement**

Each SD and MSP is required to have periodic audits, conducted by an independent internal or external auditor, that are sufficient to identify any material weakness in its documentation policies and procedures. SDs and MSPs are to retain the results of such audits.<sup>44</sup>

### END USER EXCEPTION DOCUMENTATION (SECTION 23.505)

For swaps not required to be cleared, each SD and MSP is required to “obtain documentation sufficient to provide a reasonable basis on which to believe that its counterparty meets the statutory conditions required for an exception from a mandatory clearing requirement, as defined in Section 2h(7) of the Commodity Exchange Act<sup>45</sup> and Section 39.6 of the CFTC regulations implementing Dodd-Frank.”<sup>46</sup>

The required documentation includes documentation indicating:

- The identity of the counterparty.
- The counterparty has elected not to clear a particular swap under Section 2h(7) of the Commodity Exchange Act and Section 39.6.
- The counterparty is a non-financial entity, as defined in Section 2h(7)(C) of the Commodity Exchange Act.
- The counterparty is hedging or mitigating a commercial risk.
- The counterparty generally meets its financial obligations associated with non-cleared swaps.<sup>47</sup>

However, the SD or MSP need not obtain documentation of the items specified in the last three bullet points above if it obtains documentation to the effect that its counterparty has reported such information to a swap data repository.<sup>48</sup>

### RECORDKEEPING

Records required to be maintained under the final rules are to be maintained in accordance with 17 C.F.R. § 23.203, which generally requires SDs and MSPs to keep records for a period of five years from the date the record was made, but in the case of records relating to swaps, generally requires SDs and MSPs to keep records for a period of five years after the relevant swap’s termination, maturity, expiration, transfer, assignment or novation. Records are to be made available to regulators.<sup>49</sup>

### NOTES

<sup>1</sup> See 77 Fed. Reg. 55904 (Sept. 11, 2012).

<sup>2</sup> The CFTC has addressed the definitions of “swap dealer” and “major swap participant” in a previous rulemaking. See Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 17 C.F.R. Part 1 (May 23, 2012).

<sup>3</sup> The Nov. 12 date accounts for the weekend of Nov. 10. As part of the release of the final rules, the CFTC postponed compliance dates for a number of its other rulemakings, including Sections 23.402; 23.410(c); 23.430; 23.431(a)-(c); 23.432; 23.434(a)(2), (b), and (c); 23.440; and 23.450. 77 Fed. Reg. at 55942. A discussion of these provisions and their postponement is outside the scope of this article.

<sup>4</sup> See 77 Fed. Reg. at 55918.

<sup>5</sup> 17 C.F.R. § 23.500(a).

<sup>6</sup> “Confirmation means the consummation (electronically or otherwise) of legally binding documentation (electronic or otherwise) that memorializes the agreement of the counterparties to all of the terms of a swap transaction. A confirmation must be in writing (whether electronic or otherwise) and must legally supersede any previous agreement (electronically or otherwise). A confirmation is created when an acknowledgment is manually, electronically, or by some other legally equivalent means, signed by the receiving counterparty.” 17 C.F.R. § 23.500(c).

<sup>7</sup> 17 C.F.R. §§ 23.501(a)(1) and (2).

- <sup>8</sup> A “financial entity” for these purposes is “a counterparty that is not a swap dealer or a major swap participant and that is one of the following: (1) A commodity pool as defined in Section 1a(5) of the Commodity Exchange Act, (2) A private fund as defined in Section 202(a) of the Investment Advisors Act of 1940, (3) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974, (4) A person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956, and (5) a security-based swap dealer or a major security-based swap participant.” 17 C.F.R. § 23.500(e).
- <sup>9</sup> 17 C.F.R. §§ 23.501(a)(3)(i) and (ii).
- <sup>10</sup> 17 C.F.R. § 23.501(a)(3)(iii).
- <sup>11</sup> 17 C.F.R. § 23.501(b)(1).
- <sup>12</sup> See 77 Fed. Reg. at 55925.
- <sup>13</sup> 17 C.F.R. § 23.501(a)(4)(i).
- <sup>14</sup> 17 C.F.R. § 23.501(a)(4)(ii).
- <sup>15</sup> 17 C.F.R. § 23.501(a)(4)(iii).
- <sup>16</sup> 17 C.F.R. § 23.500(i).
- <sup>17</sup> 17 C.F.R. § 23.502(d).
- <sup>18</sup> 17 C.F.R. §§ 23.502(a)(1), (2) and (3).
- <sup>19</sup> 17 C.F.R. § 23.502(a)(3).
- <sup>20</sup> 17 C.F.R. § 23.502(a)(4).
- <sup>21</sup> 17 C.F.R. § 23.502(a)(5).
- <sup>22</sup> *Id.*
- <sup>23</sup> 17 C.F.R. § 23.502(b)(1).
- <sup>24</sup> 17 C.F.R. § 23.502(b)(3).
- <sup>25</sup> 17 C.F.R. § 23.502(b)(4).
- <sup>26</sup> *Id.*
- <sup>27</sup> 17 C.F.R. § 23.502(c).
- <sup>28</sup> See 17 C.F.R. § 23.500(b) and (h).
- <sup>29</sup> 17 C.F.R. § 23.503(c).
- <sup>30</sup> 17 C.F.R. § 23.503(a).
- <sup>31</sup> 17 C.F.R. §§ 23.503(a)(3)(i) and (ii).
- <sup>32</sup> 17 C.F.R. § 23.503(b).
- <sup>33</sup> On this point the text of the final rule set out in 17 C.F.R. § 23.505 refers to Section 39.12(b)(6), under which a derivatives clearing organization is required to have rules under which, among other things, when a swap is accepted for clearing, the original swap is extinguished and replaced by an equal and opposite swap between the derivatives clearing organization and each clearing member acting as principal for a house trade or acting as agent for a customer trade.
- <sup>34</sup> 17 C.F.R. § 23.504(a)(1).
- <sup>35</sup> 17 C.F.R. § 23.504(a)(2).
- <sup>36</sup> 17 C.F.R. § 23.504(b)(1).
- <sup>37</sup> The CFTC in July of this year reopened the public comment period for margin requirements for uncleared swaps. See CFTC release PR6297-12 (July 6, 2012). It has not yet finalized the related regulations.
- <sup>38</sup> 17 C.F.R. § 23.504(b)(3).
- <sup>39</sup> 17 C.F.R. § 23.504(b)(4)(i).
- <sup>40</sup> 17 C.F.R. § 23.504(b)(4)(ii).
- <sup>41</sup> 17 C.F.R. § 23.504(b)(4)(iii).

<sup>42</sup> See 17 C.F.R. § 23.504(b)(5).

<sup>43</sup> 17 C.F.R. § 23.504(b)(6).

<sup>44</sup> 17 C.F.R. § 23.504(c).

<sup>45</sup> 7 U.S.C. § 1.

<sup>46</sup> Under Section 723 of Dodd-Frank, which sets out the text of Commodity Exchange Act Section 2h(7), as implemented under Section 39.6 of the CFTC's regulations, the mandatory clearing requirement of Dodd-Frank does not apply if one counterparty to a swap is not a financial entity, is using swaps to hedge or mitigate commercial risk, and notifies the CFTC how it generally meets its financial obligations associated with entering into uncleared swaps. See Dodd-Frank, Section 723(a)(3) and 17 C.F.R. § 23.505(a).

<sup>47</sup> 17 C.F.R. §§ 23.505(a)(1)-(5).

<sup>48</sup> 17 C.F.R. § 23.505(a); 77 Fed. Reg. at 55916.

<sup>49</sup> 17 C.F.R. §§ 23.501(b)(2), 23.502(e), 23.503(d)(2), 23.504(d) and 23.505(b); see also § 23.203(b).



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