



K&L GATES

2016 INVESTMENT MANAGEMENT CONFERENCE

CFTC and Derivative Developments

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AGENDA

- SEC's Proposed New Limits on Derivative Use
- CFTC Updates and Developments
- New Margin Requirements
- Derivatives Documentation- Variation Margin, Stay Protocol and Brexit
- Global Derivatives Regulatory Update





SEC's Proposed New Limits on Derivative Use

SUMMARY OF PROPOSED RULE

- The SEC designed the rule to provide a “modernized, more comprehensible approach” to derivatives regulation
- The proposed rule would limit the way mutual funds, closed-end funds, and ETFs use derivatives and create risk management measures designed to protect investors
 - Portfolio limitations
 - Asset segregation
 - Risk management program
- The rule would replace the existing asset segregation regime developed over the last 35+ years



REQUIREMENTS FOR DERIVATIVES: PORTFOLIO LIMITATIONS FOR DERIVATIVES TRANSACTIONS

- A fund must comply with one of two portfolio limitations, designed to limit leverage the fund may obtain through derivatives and financial commitment transactions
 - *Exposure-based portfolio limit*
 - Aggregate exposure cannot exceed 150% of net assets
 - Exposure is the sum of the aggregate notional amount of derivative transactions, financial commitment transactions, and other senior security transactions
 - *Risk-based portfolio limit*
 - Aggregate exposure is limited to 300% of net assets *if* the fund can satisfy a risk-based test
 - The VaR-based test is intended to determine if the *aggregate* effect of derivatives transactions decreases the market risk of the fund's portfolio
- The exposure limits are *in addition to* exposure from the fund's securities portfolio



REQUIREMENTS FOR DERIVATIVES: ASSET SEGREGATION FOR DERIVATIVES TRANSACTIONS

- A fund must segregate certain assets equal to the sum of two amounts:
 - *Mark-to-market coverage amount.* The amount the fund must pay to exit the derivative transaction
 - May be reduced by variation margin
 - *Risk-based coverage amount.* A reasonable estimate of what the fund would pay to exit the derivatives transaction under stressed conditions
 - Determined by the fund's board of directors
 - May be reduced by initial margin
- Only cash and cash equivalents may be used to meet the segregation requirement
- *Note:* Different rules apply for financial commitment transactions



ASSET SEGREGATION: REQUIREMENTS FOR FINANCIAL COMMITMENT TRANSACTIONS

- A fund that enters into financial commitment transactions must segregate assets equal to the *full amount* of cash or other assets the fund is obligated to pay or deliver
- “Financial commitment transactions” include:
 - Reverse repurchase agreements
 - Short sale borrowing
 - Firm or standby commitment agreements (or similar agreements)
- Pledged collateral may be used as segregated assets



REQUIREMENTS FOR DERIVATIVES: DERIVATIVES RISK MANAGEMENT PROGRAM

- Funds that engage in complex derivatives transactions or that trade derivatives frequently (*i.e.*, notional exposure >50% of NAV) must develop a formalized derivatives risk management program
- The fund's board of directors must:
 - Review and approve the program
 - Receive quarterly risk reports
 - Appoint a derivatives risk manager
- This requirement is *in addition* to the broader risk management requirements that apply to all funds



DISCLOSURE AND REPORTING

- The proposed amendment would require each fund with a derivatives risk management program to disclose risk metrics related to its use of certain derivatives on proposed Form N-PORT
- The proposed amendment would require a fund to disclose identify the portfolio limitation(s) on which it relied (*i.e.*, exposure based or risk based) during the reporting period on proposed Form N-CEN



CHANGES FROM CURRENT REGULATORY SCHEME:

CURRENT SCHEME

- *Limits on leverage.* Permitted senior debt securities must meet 300% asset coverage ratio; no cap on leverage obtained through derivative positions if segregation obligations are met
- *Derivatives risk manager.* No derivatives risk manager or risk management program
- *Segregation of assets.* Must segregate any **liquid assets** sufficient to meet obligations equal to **mark-to-market exposure amount** (derivatives that net settle in cash) **or full notional amount** of obligation (derivatives that physically settle and CDS)

PROPOSED SCHEME

- Asset coverage requirements for senior debt securities remain
– and –
Absolute ceiling on leverage senior security-like transactions equal to 150% NAV, or 300% NAV if the fund satisfies the risk-based test
- Must appoint derivatives risk manager if fund engages in frequent/complex derivatives transactions
- Must segregate cash or cash equivalents sufficient to meet obligations equal to:
- Mark-to-market exposure for derivatives
 - Entire obligation for financial commitment transactions



COMMISSIONER PIWOWAR'S RECENT REMARKS

- At an October 12 conference at Georgetown University, SEC Commissioner Michael Piwowar said he did not foresee approval for the proposal in 2016, preferring to wait until after the elections
 - SEC Chair Mary Jo White originally identified finalizing the rule among her priorities for 2016, but the next U.S. President could replace White with a new chair
 - Questions remain as to how derivatives caps would affect leveraged funds and their abilities to hedge
 - Piwowar originally voted against releasing the proposal because the SEC had not yet gathered relevant data





CFTC Updates and Developments

REGULATION AT

- November 24, 2015: CFTC proposed regulations that would govern automated trading on designated contract markets (“DCM”)
 - The rule is aimed at “AT Persons” (generally High-Frequency Traders)
 - Can include registered commodity pool operators (“CPO”) and commodity trading advisers (“CTA”) that engage in automated trading
- AT Person requirements:
 - Pre-trade risk controls
 - Written policies and procedures regarding software development, testing and training
 - Submission of an annual report regarding a firm’s automated trading activities
 - Maintenance of a source code repository open to inspection by any CFTC staff member or the U.S. Department of Justice
- June 10, 2016: CFTC held a public roundtable to further discuss the proposed rule, and re-opened comment period to June 24, 2016



EXEMPTION FROM REGISTRATION FOR NON-U.S. INTERMEDIARIES

- CFTC Regulation 3.10(c)(3)(i) exempts certain non-U.S. intermediaries from registration under the CEA for transactions submitted for clearing through a CEA-registered FCM
 - The non-U.S. intermediary may only act on behalf of non-U.S. customers, clients and investors
- CFTC no-action letter – permits an intermediary conducting some transactions involving uncleared swaps that could otherwise claim this exemption to continue to do, so provided there is no clearing mandate for such swaps
 - Issued in response to an argument that the clearing requirement is unreasonable for swaps for which the CFTC has not adopted a clearing mandate



CYBERSECURITY

- NFA adopted, effective as of March 1, 2016, an Interpretative Notice entitled Information Systems Security Programs (“ISSP”), which applies to all member firms, including registered CPOs and CTAs. The major elements of the cybersecurity guidance include:
 - Written ISSP
 - Program should be approved, in writing, by the member’s chief executive officer, chief technology officer, or other executive-level official
 - Senior management should provide periodic board reports (or reports to a similar governing entity) to enable the board to monitor the firm’s information security efforts
 - Security and risk assessment, including risks of third-party service providers
 - Deployment of protective measures against identified threats and vulnerabilities
 - Response and recovery from events that threaten the security of electronic systems
 - Employee training
 - Recordkeeping
 - If CPO/CTA is a unit or affiliate of a larger enterprise, may be able to rely generally on the enterprise-wide policy



RE-AFFIRMATION OF EXEMPTIONS FROM REGISTRATION

- Don't forget that exemptions from registration under the CEA must now be re-affirmed on an annual basis!
 - For investment managers:
 - CFTC Regulation 4.5- claims of CPO exemption for operators of certain types of collective investment vehicles
 - CFTC Regulation 4.13(a)(3)- claims of CPO exemption based upon a *de minimis* amount of commodity interest trading by the pools operated
 - CFTC Regulation 4.14(a)(8)- claims of exemption from CTA registration based upon the type of investment vehicle a firm advises
- Due date for reaffirmation is March 1 of ***each year***
- Reaffirmations must be made using NFA's Electronic Exemption System



OPEN ISSUES

- Liquidation audit for “Harmonized” funds
 - Not explicitly addressed by the Harmonization rule
 - Difficult to apply to mutual funds—who will receive liquidation audits, and how?

- CPOs to funds-of-funds
 - Continued reliance on Letter 12-38 pending updated guidance

- New position limits rule
 - CFTC Chairman Massad recently indicated that the CFTC still plans to finalize its position limits rule before the end of the year





New Margin Requirements

A NEW REGIME

- Imposes initial margin (IM) and variation margin (VM) requirements on covered swap entities
- The Prudential Regulators released final rules and guidance (“Prudential Rules”) on October 22, 2015, followed by the CFTC’s final rule release on December 16, 2015 (“CFTC Rules”), later supplemented by the cross-border rules for margin released May 26, 2016
 - Due to substantial harmonization the two sets of final rules are largely interchangeable
- The first stage on a phased implementation process got underway October 2, 2016
- Global development



COVERED SWAP ENTITIES

- The final rules apply to “covered swap entities” (“CSEs”)
 - The Prudential Rules apply to registered Swap Dealers (“SD”), Major Swap Participants (“MSP”), Security-based Swap Dealers (“SBSD”) and Major Security-based Swap Participants (“MSBSP”) regulated by a prudential regulator
 - The CFTC Rules apply to SDs and MSPs not regulated by a prudential regulator
- SBSDs and MSBSPs not regulated by a prudential regulator will be subject to the SEC’s margin rules, once they are in place



COVERED COUNTERPARTIES

- The margin obligations of CSEs vary depending on whether the counterparty to the swap is a:
 - Swap Entity
 - Financial End User with Material Swaps Exposure
 - Entity and its affiliates have an average daily aggregate notional amount of uncleared derivatives with all counterparties in excess of \$8 billion in June, July and August of the previous calendar year
 - Financial End User without Material Swaps Exposure
 - Other counterparty, including non-financial end users, sovereigns and multilateral development banks
- Financial End Users
 - Broadly captures entities engaging in financial activities, including:
 - Banks, broker-dealers, Investment advisers, mutual funds and private funds, commodity pools, CPOs and CTAs, certain employee benefit plans, insurance companies



COVERED SWAPS

- The Prudential Rules apply to swaps and security-based swaps that are not cleared with a derivatives clearing organization registered with the CFTC or a clearing agency registered with the SEC
- The CFTC Rules apply to swaps (but not security-based swaps) that are not with a derivatives clearing organization registered with the CFTC
- Exceptions:
 - FX Swaps
 - FX Forwards
 - The principal in cross-currency swaps
- Does apply to NDFs



MECHANICS

- Minimum Transfer Amount
- Thresholds – IM only
- Transfer timing – T+1
- Eligible Collateral
- Segregation – IM only



INITIAL MARGIN IMPLEMENTATION DATES

THRESHOLD	COMPLIANCE DATE
2016, greater than \$3 trillion	October 2, 2016*
2017, greater than \$2.25 trillion	September 1, 2017
2018, greater than \$1.5 trillion	September 1, 2018
2019, greater than \$0.75 trillion	September 1, 2019
Any other entity with material swaps exposure	September 1, 2020

*Delayed from September 1, 2016

- Majority of buy-side clients will not meet the threshold requiring posting of an initial margin



VARIATION MARGIN IMPLEMENTATION DATES

ENTITIES	COMPLIANCE DATE
2016, greater than \$3 trillion	October 2, 2016*
All other applicable counterparties	March 1, 2017

*Delayed from September 1, 2016

- Majority of buy-side parties will fall into the second, “big bang” category
- Prudent approach – prepare to post variation margin by March 1, 2017



CROSS-BORDER APPLICATION

- Prudential Rules do not apply to swaps or security-based swaps between a non-US CSE and a counterparty which is not organized under US law, a branch of an entity organized under US law, a SD, MSP, SBSD or MSBSP that is a subsidiary of an entity organized under US law
- CFTC cross-border rules excludes from the CFTC rules swaps if between:
 - Non-US CSE is not a US Person, is not guaranteed by a US Person, is not a foreign consolidated subsidiary and is not trading through a US branch; and
 - Counterparty is not a US Person, is not guaranteed by a US Person, is not a CSE (or if a CSE, is not a foreign consolidated subsidiary), and is not trading through a U.S. branch
 - “arranged, negotiated or executed”





Derivatives Documentation- Variation Margin

MARGIN DOCUMENTATION

- Margin rules require documentation that provides the CSE with contractual right and obligation to exchange IM and VM in accordance with the rules
- Market participants will have to modify their existing credit support documentation or put in place new documentation
- Two key ISDA initiatives
 - ISDA Regulatory Margin Self-Disclosure Letter
 - Available since June
 - Helps market participants exchange necessary information to determine whether and when their trading relationship will become subject to the margin requirements in the U.S., Canada, EU, Japan and Switzerland
 - Available on ISDA Amend
 - ISDA 2016 Variation Margin Protocol (“VM Protocol”)
 - Open since August 16, 2016, soon available on ISDA Amend



ISDA 2016 VM PROTOCOL

- Purpose is to facilitate the implementation of margin requirements by market participants
- Currently applies to four regimes:
 - Prudential Rule, CFTC, Canada, and Japan
 - Will publish supplementary documentation after corresponding regulations in the EU and Switzerland are finalized to ensure those regimes are within the protocol's scope
- Targets the March 1, 2017 “big bang” implementation date



HOW PROTOCOL HELPS PARTIES

- Enables parties to determine which regulatory regimes might be applicable to their swap trading relationship by eliciting the exchange of certain information
- Parties can amend documentation to comply with margin requirements
- “Strictest of” procedure where counterparty pair is subject to multiple regimes and the applicable rules under each regime are different



FOUR WAYS TO UPGRADE

- New CSA Method
 - Add a new CSA to an existing 1992 or 2002 Master Agreement
 - CSA terms determined by VM Protocol and parties' matched questionnaires
 - New CSA covers new transactions – legacy transactions remain under parties' existing CSA
- Replicate-and-Amend Method
 - Amend existing Master Agreement and CSA by creating replica of existing CSA
 - Replica CSA is amended to comply with Margin Rules – replica CSA covers new transactions, legacy transactions remain under the existing CSA
- Amend Method
 - Parties amend existing CSA to comply with Margin Rules – covers all transactions
- Creation of Master Agreement
 - Enter into new 2002 Master Agreement with a new VM-compliant CSA
 - Master Agreements terms determined by VM Protocol and the parties' matched questionnaires
 - CSA terms determined by New CSA Method





Derivatives Documentation- Brexit

BREXIT – WHERE ARE WE NOW?

- UK voted to leave EU on June 24, 2016
 - UK government will invoke Article 50 of the Lisbon Treaty no later than the end of March 2017
 - Great Repeal Bill – May 2017
 - It is likely the UK will be outside of the EU single market, at least for some period
- Implications for Derivatives
 - Short term – Know Knowns
 - Long term – Known Unknowns



KNOWN KNOWNS

- No significant changes in regulatory structure of derivatives market in immediate future
- EMIR
 - Remains in effect for the time being
 - UK regulator has made clear it will comply with any elements of EMIR and MiFID II that come into effect between now and the UK's formal exit from the EU
 - Notably, including margining for uncleared derivatives



KNOWN UNKNOWNNS

- Implications post-Brexit depend on the exit model agreed upon by UK and EU authorities at the end of the exit negotiation period
 - Will passporting arrangements continue to apply?
 - Will EU entities subject to the clearing obligation under EMIR be able to clear through UK central counterparties?
- The EU may consider the UK a third country for purposes of EMIR
 - Without a general equivalence decision, UK-based TRs and CCPs must apply for recognition from ESMA to continue to provide services to EU counterparties
 - Despite existing EMIR-compliance, obtaining recognition may take longer than expected
 - UK banks, currently clearing members of an EU CCP, might fail to meet their EU CCPs' eligibility criteria



KNOWN UNKNOWNNS cont.

- Bank Recovery and Resolution Directive (BRRD)
 - The UK is a strong proponent of insolvency and resolution regime of which BRRD forms part
 - While unlikely that post-Brexit UK-based banks would see meaningful change to requirements in this area, there could be an impact on Article 55 “Bail-in”



IMPACT ON ISDA DOCUMENTATION

- Article 55 Re-papering exercise would be substantial
- Resolution Stay Modular Protocols matching UK and EU counterparties may be needed
- Some good news: Brexit is unlikely to trigger a standard event of default or early termination event
- Brexit could result in the early termination event if specific termination events built into an agreement relate to the investment manager of a transacting entity losing the right to do business in a relevant jurisdiction



IMPACT ON ISDA DOCUMENTATION cont.

- Part 5 provisions in individual Schedules
 - Counterparties should consider reviewing for terms impacted by Brexit especially in ISDAs subject to EU regulation
- It is unclear if the current “passporting” of English judgments will continue after Brexit
 - Parties may consider incorporating into their ISDA Master Agreements one of ISDA’s model arbitration clauses in lieu of submission to the jurisdiction of English Courts
 - Brexit is not expected to impact the enforceability of foreign arbitral awards



INVENTORY AND WAIT

- ISDA historically has used online protocols to handle industry-wide changes
 - Parties adhere to protocols, update all existing documentation in the process
 - Expect a similar approach to taken
- ISDA counterparties should inventory and take a “wait and see” approach before repapering any specific terms





ISDA Stay Protocol

ISDA RESOLUTION STAY JURISDICTIONAL MODULAR PROTOCOL - BACKGROUND

- In the US and other jurisdictions, parties to qualified financial contracts (QFCs) benefit from a safe harbor from the automatic stay of certain enforcement rights under insolvency laws
 - Allows funds to terminate QFCs immediately upon the insolvency of a counterparty and set off claims against collateral
- After 2008 financial crisis, regulators in the U.S. and other G-20 countries were given enhanced powers over large financial institutions under special resolution regimes
 - These include the ability to suspend or “stay” the termination rights and remedies of **any** counterparty to a contract with the insolvent institution
 - The goal is to allow the regulator to transfer the insolvent institution’s assets and liabilities to creditworthy entities or liquidate the entity in an orderly manner
- In the U.S., Title II of Dodd-Frank Act created the Orderly Liquidation Authority
- Similar Regulations are being enacted in Europe, Japan and elsewhere



ISDA RESOLUTION STAY JURISDICTIONAL MODULAR PROTOCOL - THE MISSING LINK

- A regulator's "resolution stay" powers clearly can be enforced within its home jurisdiction
- But it is not clear that they would be enforced by foreign courts with respect to contracts governed by foreign laws
- Example:
 - Lehman Brothers (US) entered into a swap with Deutsche Bank (Germany) governed by UK law
 - SIPC (US) seeks to stay Deutsche Bank's termination and close-out rights against Lehman under UK law
 - Deutsche Bank seeks to set off its liabilities to Lehman subsidiaries (Japan) in contracts governed by Hong Kong law



ISDA RESOLUTION STAY JURISDICTIONAL MODULAR PROTOCOL - HOW DOES IT WORK?

- To resolve this issue, regulators (such as the FRB in the US) have issued implementing regulations that prohibit regulated institutions from entering into financial contracts ***unless the counterparty contractually agrees to adhere to the home country's resolution stay laws.***
- The ISDA Protocol is designed to allow participants to amend all covered financial contracts to make this representation
 - ISDA has published (and will publish) country-specific Modules under the protocol, to address the implementing regulations of each country as they become effective
- Bilateral agreements remain an option, but swap dealers seem to prefer the “one-stop-shop” aspect of the Protocol
- The form of adherence letter presents funds with several choices regarding ***which*** sell-side counterparties will be covered under the Protocol, each fund will need to weigh its options in light of its current (and expected) trading





Global Derivative Regulatory Update

RECENT GLOBAL DEVELOPMENTS

- Margin
 - Margin requirements active in Canada and Japan
 - EMIR margin requirements delayed
- Clearing
 - Interest rate swaps
 - CDS
- Other Issues

