



K&L GATES

2017 BOSTON INVESTMENT MANAGEMENT CONFERENCE

# CFTC and Derivatives Developments

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# AGENDA

- CFTC Updates and Developments
- Margin Update
- Cross-Border Issues
- Federal Reserve QFC Rule
- New Treasury Recommendations

The image features a dark background with a glowing blue bar chart and a red line graph. The chart shows a series of vertical bars of varying heights, with a red line connecting the tops of several of them, indicating a trend. The overall aesthetic is digital and data-oriented.

# CFTC Updates – Regulation 4.13(a)(4) and Regulation 4.5

# REINSTATEMENT / REVERSION OF CFTC REGULATIONS 4.13(a)(4) AND 4.5

- Current status of CPO/CTA exemptions
- AIMA Petition
- “K.I.S.S.” Letters
- Regulation 4.13(a)(4) additional conditions:
  - SEC registration
  - Foreign
- Potential ICI Petition



# Margin Update



# MARGIN REQUIREMENTS FOR UNCLEARED DERIVATIVES

- US margin rules currently apply to OTC swaps entered into on or after the applicable compliance date
  - except physically-settled FX transactions
- EU margin rules will apply to non-centrally cleared derivatives entered into on or after the applicable compliance date
  - including physically-settled FX forwards after MiFID II takes effect on January 3, 2018

# VARIATION MARGIN (VM)

- The Prudential Regulators, the CFTC and ESMA have all adopted VM rules for uncleared derivatives
  - Due to substantial harmonization, the final rules under each regime are largely interchangeable, with a few key exceptions
  - Through no-action relief, global regulators extended the variation margin rules effective date to September 1, 2017
- Key requirements under VM rules:
  - *Daily Calculation*
  - *Collection of VM*: A party required to post VM must be able to post VM collateral on the day it receives a variation margin notice
  - *Minimum Transfer Amount (“MTA”)*: Maximum is \$500K under the U.S. Rules and €500 under EU Rules – industry has settled at \$250k for norm
    - CFTC Guidance – For institutional separate accounts the MTA can be as low as \$50k, measured at the account level
  - *Eligible Collateral and Haircuts*: Each regulator has adopted a standardized set of eligible collateral and haircuts

## INITIAL MARGIN

- Compliance dates for initial margin depend on the average daily aggregate notational amount of uncleared swaps, uncleared security-based swaps, FX forwards and FX swaps for March, April and May of the applicable year
- But the earliest likely compliance date is September 1, 2020, and then only if the buy-side counterparty has Material Swaps Exposure



## POTENTIAL EU RELIEF

- On November 15, the Council of the European Union published a proposal to exempt physically-settled FX forward transactions from EMIR margin requirements
  - most major jurisdictions have excluded FX forwards from margin requirements, placing EU banks at a competitive disadvantage
  - If adopted, physically-settled FX forward transactions between non-banks and banks would be excluded from IM and VM requirements
- November 24 joint statement of ESAs: intend to draft amendments removing or deferring variation margining requirements for physically-settled FX forwards by Christmas
  - Subject to adoption by European Commission
- Proposed amendment to EMIR reporting requirements would shift burden to report derivative contracts for non-financial counterparties subject to the clearing obligation solely to the financial counterparty, easing administrative burden

## FINRA RULE 4210

- Amendment to Rule 4210 applies to FINRA-member broker-dealers
- Requires margining of forward-settling transactions
- Requires a dealer to collect both initial margin and variation margin absent an exception
- Exceptions:
  - *Trades* –non-covered agency transactions and trades cleared through and subject to the margin requirements of a clearing agency
  - *Counterparties* –registered investment companies, plans under ERISA, certain banks, and U.S. state and local governments

## FINRA RULE 4210 (CONTINUED)

- Expands margining regime for TBAs, “spec” trades, and collateralized mortgage obligations from existing TMPG Best Practices
- Differences from TMPG Best Practices:
  - Rule 4210 may require initial and variation margin, TMPG Best practices require only variation margin
  - Rule 4210 requires FINRA members only to collect initial margin and variation margin, TMPG Best Practices require bilateral margin
- In September, effective date for margin requirements extended to June 25, 2018
  - Delay comes at the request of industry participants who sought additional time to make systems changes and update margining agreements and related documentation
- SIFMA form of amendment for existing MSFTAs
  - Subject to negotiation – be aware of timing



# Cross-Border Issues



# CFTC'S EU COMPARABILITY DETERMINATION

- The CFTC determination became effective on October 13, 2017
- CFTC has determined that margin rules for uncleared swaps in the EU are comparable to CFTC margin rules
  - Allows swap dealers and majority swap participants (Covered Swap Entities or CSEs) to satisfy the CFTC final margin rule by complying with the margin requirements of a relevant foreign jurisdiction

# EUROPEAN COMMISSION EQUIVALENCE DECISIONS

- Commission decision released October 13, 2017 and effective on November 3, 2017
- EC has taken similar action to the CFTC, adopting two equivalence decisions that allow for substituted compliance:
  - A CSE subject to both CFTC and EU margin rules with respect to an uncleared swap may rely on substituted compliance wherever available under the CFTC's margin rules
    - Compliance with the EU's margin rules will be deemed proper compliance with the CFTC's margin rules
    - However, CSE will remain subject to CFTC's examination and enforcement authority
  - Substituted compliance exceptions:
    - Products covered under each regime are not identical
    - Entities subject to each regime are not identical

# EUROPEAN COMMISSION EQUIVALENCE DECISIONS (CONTINUED)

- Determination applies only to OTC swaps and does not apply to deliverable FX forwards which (presently) are subject to EU margin rules when MiFID becomes effective on January 3, 2018
  - But subject to pending changes described above
- Proposed the adoption of an equivalence decision covering the CFTC authorized and recommended swaps execution facilities and designated contract markets
  - Each must meet requirements of MiFIR, MiFID II, and the Market Abuse Regulation
- Proposed the CFTC exempt from the swaps execution facilities requirement the trading venues recommended by the European Commission and authorized in accordance with MiFID II/MiFIR requirements



# Federal Reserve QFC Rule

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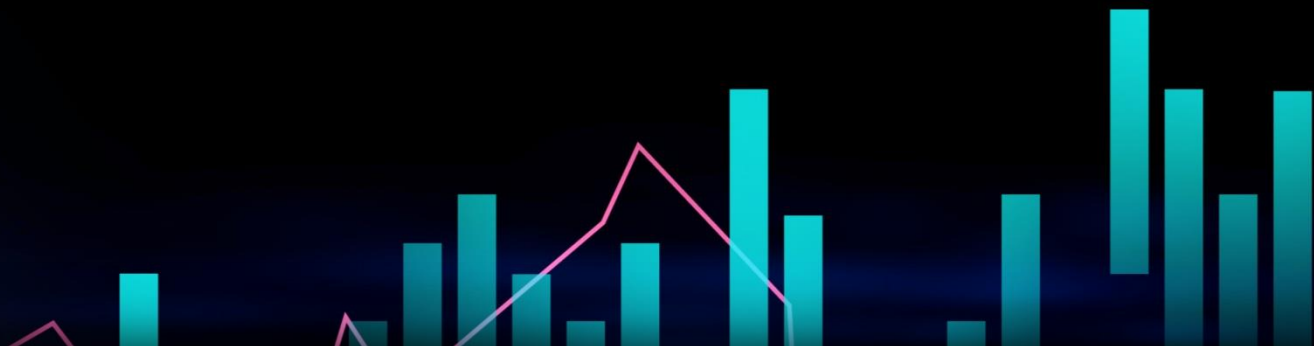


## FEDERAL RESERVE QFC RULE

- Intended to ensure cross-border enforcement of Title II of Dodd-Frank (the Orderly Liquidation Authority) and the FDIA as they apply to covered entities and limit the ability of counterparties to terminate qualified financial contracts (QFCs), such as derivatives, repurchase agreements and securities lending agreements, upon the entry of a global systemically important bank (GSIB) or its affiliates into insolvency proceedings
  - Centrally cleared QFCs are excluded as are, with respect to non-U.S. GSIBs, certain transactions booked with their non-U.S. offices
- “Covered entities” subject to the Rule include all U.S. GSIBs other than excluded banks and certain subsidiaries, and U.S. operations of non-U.S. GSIBs

## FEDERAL RESERVE QFC RULE (CONTINUED)

- Requires the QFCs of covered entities to contain contractual provisions that opt into the temporary stay-and-transfer treatment of the Federal Deposit Insurance Act and Dodd-Frank
  - Reduces the risk that the stay-and-transfer treatment would be challenged by a QFC counterparty or court in a foreign jurisdiction
- Prohibits covered entities from entering into QFCs that contain cross-default rights
- Compliance dates:
  - Financial counterparties (including registered investment companies): July 1, 2019
- Substantively identical FDIC rule on QFCs applies to banks subject to FDIC regulation and becomes effective January 1, 2018
- ISDA Protocol



# New Treasury Recommendations



## SECOND REPORT ON DERIVATIVES

- Treasury report suggests widespread support for mandated central clearing and platform trading of standardized derivatives, as well as trade reporting, but criticism regarding details of implementation and recommendations represent a significant lightening of the Dodd-Frank derivatives regime

# SECOND REPORT ON DERIVATIVES (CONTINUED)

- Treasury Report Recommendations:
  - CFTC and SEC should jointly review rulemakings regarding swaps and security-based swaps
  - CFTC and U.S. banking agencies should harmonize domestic margin requirements
  - U.S. banking agencies should consider amendments to allow for more realistic time frames for collecting and posting margin
  - CFTC should simplify and formalize staff guidance and no-action letters used to smooth implementation of the Dodd-Frank swaps regulatory framework
  - CFTC and SEC should provide clarity regarding cross-border scope of their regulations and make rules compatible with non-U.S. jurisdictions

# SECOND REPORT ON DERIVATIVES (CONTINUED)

- Treasury Report Recommendations:
  - CFTC should maintain the swap dealer de minimis registration threshold at \$8 billion
  - CFTC should complete its position limits rules
  - CFTC should focus on standardizing reporting fields across products and SDRs and harmonize reporting requirements with other regulators

## THIRD TREASURY REPORT ON DERIVATIVES

- Third treasury report contains substantial commentary on December 2015 SEC derivatives rule proposal
- Treasury adopts many criticisms of the industry:
  - Portfolio limits could unnecessarily restrict use of derivatives for liquidity, hedging or other risk mitigating purposes
  - Gross notional amount is not necessarily correlated with leverage or risk levels, and not an appropriate measure for derivatives exposure in registered funds
  - Limiting qualifying coverage assets to cash and cash equivalents could reduce investment returns and cause unnecessary tracking error

# THIRD TREASURY REPORT ON DERIVATIVES (CONTINUED)

- Report Recommendations
  - Treasury supports a final rule that includes a derivatives risk management program and an asset segregation requirement
    - Comprehensive approach is an improvement on “a patchwork of more than 30 no-action letters”
  - Treasury recommends:
    - Reconsider portfolio limits and, if adopted, “should be based on significantly more risk-adjusted measures.”
    - Expand qualifying coverage assets
    - Re-examine derivatives data that will be reported in N-PORT starting June 1, 2018, and publish analysis based on empirical data





Questions?

