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K&L GATES

2019 WASHINGTON, DC INVESTMENT MANAGEMENT  
CONFERENCE  
**Derivatives Updates**

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# OVERVIEW

- Market Developments: Regulatory and Compliance
- Market Developments: Transactional and Marketplace





# Market Developments: Regulatory and Compliance



## CFTC – NEW CHAIRMAN = NEW AGENDA

- CFTC Chairman Tarbert was sworn in on July 15, 2019.
- Chairman Tarbert's first public comment was that he eagerly looks forward “to ensur[ing] our derivatives markets remain vibrant and the wrongdoers are held accountable.”
- Chairman Tarbert has staffed his office and the executive leadership team with government, industry, and former law firm practitioners
- CFTC action is expected in the next six months on the following:
  - the swap dealer capital rule
  - the cross-border rule for swap dealers
  - position limits
  - enforcement penalty guidance
  - swap data reporting
  - bankruptcy rules and
  - guidance on digital assets.



# CFTC THEMATIC REVIEWS - CPOs AND CTAs

- The new Director of the Division of Swap Dealer and Intermediary Oversight (DSIO), Joshua Sterling, has set forth five building blocks for DSIO, including:
  - (1) The Examination Program,
  - (2) The Reporting Framework,
  - (3) The Guidance Program,
  - (4) The Relationship to Enforcement, and
  - (5) The Rulemaking Function.



# THE EXAMINATION PROGRAM

CFTC DSIO Director Sterling:

- We are designing a program of targeted thematic reviews of select large swap dealers and CPOs that will commence in the first quarter of 2020. These reviews will be carried out directly by Division staff...
- ...swap dealers and CPOs [are]...important actors in our markets. They provide liquidity and, in doing so, transmit, amplify, convert, hedge, price, test, and monitor certain key risks...we need to take a thematic approach to understanding better how the big shops approach key compliance issues like risk management and risk reporting.
- Our thematic reviews will focus only on selected key issues and will not duplicate or replace NFA's ongoing efforts.
- We anticipate reporting out to the market our general observations later next year, after our first round of reviews is complete.



# CFTC VISIT PREPARATION AND OUTCOME

- K&L Gates is preparing a CFTC Examination Toolkit to assist clients:
  - Prepare for a CFTC visit
  - Navigate the visit
  - Implement deficiencies and recommendations identified
  - Implement the recommendations in the review published by the CFTC.
- As an initial starting point, K&L Gates has many off-the-shelf compliance manuals and workflows that allow clients to implement a **baseline, market standard approach** to CFTC regulatory oversight.



# THE GUIDANCE PROGRAM

- Market participants should expect that the CFTC will “better...convey our expectations about compliance requirements and emerging issues to market participants.”
- DSIO will be “formalizing” their communications program for registrants, to provide more general guidance on a more frequent basis than in the past.
- Practical Implication: DSIO will reduce the use of no-action relief for specific parties.
  - See e.g., Statement by the Directors of the Division of Clearing and Risk and the Division of Swap Dealer and Intermediary Oversight Concerning the Treatment of Separate Accounts of the Same Beneficial Owner (September 13, 2019).



# THE RELATIONSHIP TO ENFORCEMENT

- DSIO is “strengthening” its “relationship with the Division of Enforcement with a more focused approach to referrals, so that our coordination efforts become more programmatic.”
- Director Sterling also stated that “we are going to be more **focused and programmatic** in what we do if we see potential red flags in the ordinary course of our reviews. After all, Enforcement should reinforce our oversight function by **holding registrants accountable**, and we should support Enforcement by flagging potential problems that we encounter.”



# DERIVATIVES TRADING COMPLIANCE & ENFORCEMENT

- Just as DSIO is undertaking a program to review registrants, the Division of Market Oversight (DMO) is undertaking a review of swap execution facilities (SEFs), similar to the rule enforcement reviews that have been conducted for futures exchanges.
- The practical outcome is increased scrutiny of derivatives trading on SEF and off-SEF.



# CFTC RELIEF ON SEPARATELY MANAGED ACCOUNTS

- On July 10, 2019, the Division of Clearing and Risk (DCR) and the Division of Swap Dealer and Intermediary Oversight (DSIO) issued Letter #19-17 as a joint staff advisory interpretation, and DCR issued time limited no-action relief letter related to the treatment of separate accounts by FCMs
- The Relief was necessary given the confusion created by certain JAC Regulatory Alerts released earlier this year and how the JAC Alerts relate to separately managed accounts (SMAs)
- The Relief addresses a FCM's ability to access a Beneficial Owner's funds from accounts outside a specific SMA and FCM margining practices for customers with more than one futures account, and consequently, relates to asset managers and their customers who use SMAs



# UPCOMING CPO AND CTA RULE CHANGES

- Offshore pools and CFTC Rule 3.10(c)(3)(i)
  - CFTC Rule 3.10(c)(3)(i) exempts non-U.S. persons from registration as a CTA or CPO for particular non-U.S. commodity interest transactions if certain conditions are met
- CFTC proposal to amend commodity pool regulations
  - The proposal sought to provide greater regulatory certainty to market participants by including relief set out in various staff no-action letters directly to the CFTC's regulations
  - The proposal would affect not only registered CPOs and CTAs, but also persons exempt from registration as a CPO or CTA, including offshore CPOs/CTAs, business development companies and their investment advisers, and “family offices”
- Latest advocacy issues



# UPCOMING CPO AND CTA RULE CHANGES

The proposal would:

- (1) permit CPOs that only solicit and/or accept funds from non-U.S. investors to claim a new exemption from registration and compliance requirements with respect to such pools;
- (2) permit U.S.-based CPOs of offshore commodity pools with U.S. participants to maintain the pool's original books and records in the pool's offshore location;
- (3) provide registration relief for the CPOs and CTAs of entities qualifying as family offices and IAs of BDCs;
- (4) permit qualifying CPOs to engage in general solicitation with respect to their pool offerings
- (5) relieve certain CPOs and CTAs of the requirement to file Forms CPO-PQR and CTA-PR; and
- (6) require CPOs claiming exemption from registration to represent that they are not subject to statutory disqualification from registration





# Market Developments: Transactional and Marketplace



# INTRODUCTION

- Why do 1940 Act Funds use derivatives?
- Documentation:
  - ISDAs: Boilerplate, Schedule, CSA, Control Agreement
  - Master Repurchase Agreements
  - Master Securities Forward Transaction Agreements
  - Clearing Agreements
- 1940 Act issues: Custody



# MARGIN FOR UNCLEARED SWAPS AND OTHER DERIVATIVES

- Variation Margin
- CFTC and U.S. Prudential Regulators proposed rules to delay implementation of IM for Phase 5 smaller market participants until **September 1, 2021**
  - **Phase 4:**
    - Qualifying level: \$.75 trillion
    - Effective Date: September 1, 2019
  - **Phase 5:**
    - Qualifying level: currently \$8 billion [proposed change to \$50 billion]
    - Effective Date: September 1, 2020
  - **Phase 6: [Proposed]**
    - Qualifying level: \$8 billion
    - Effective Date: September 1, 2021
- On July 9, 2019, the CFTC issued a Staff Advisory to clarify documentation requirements for uncleared swaps will not apply until a firm exceeds a \$50 million IM threshold



## MARGIN FOR UNCLEARED SWAPS (CONT.)

- In-Scope Entities & Margin Affiliates
- Thresholds and Calculations
- Self-disclosure
- Remaining advocacy and implementation issues:
  - AANA scoping
    - SIFMA AMG Client Outreach Letter
  - IM threshold calculations – request for annual measurements
  - MMF issues
- FINRA Rule 4210

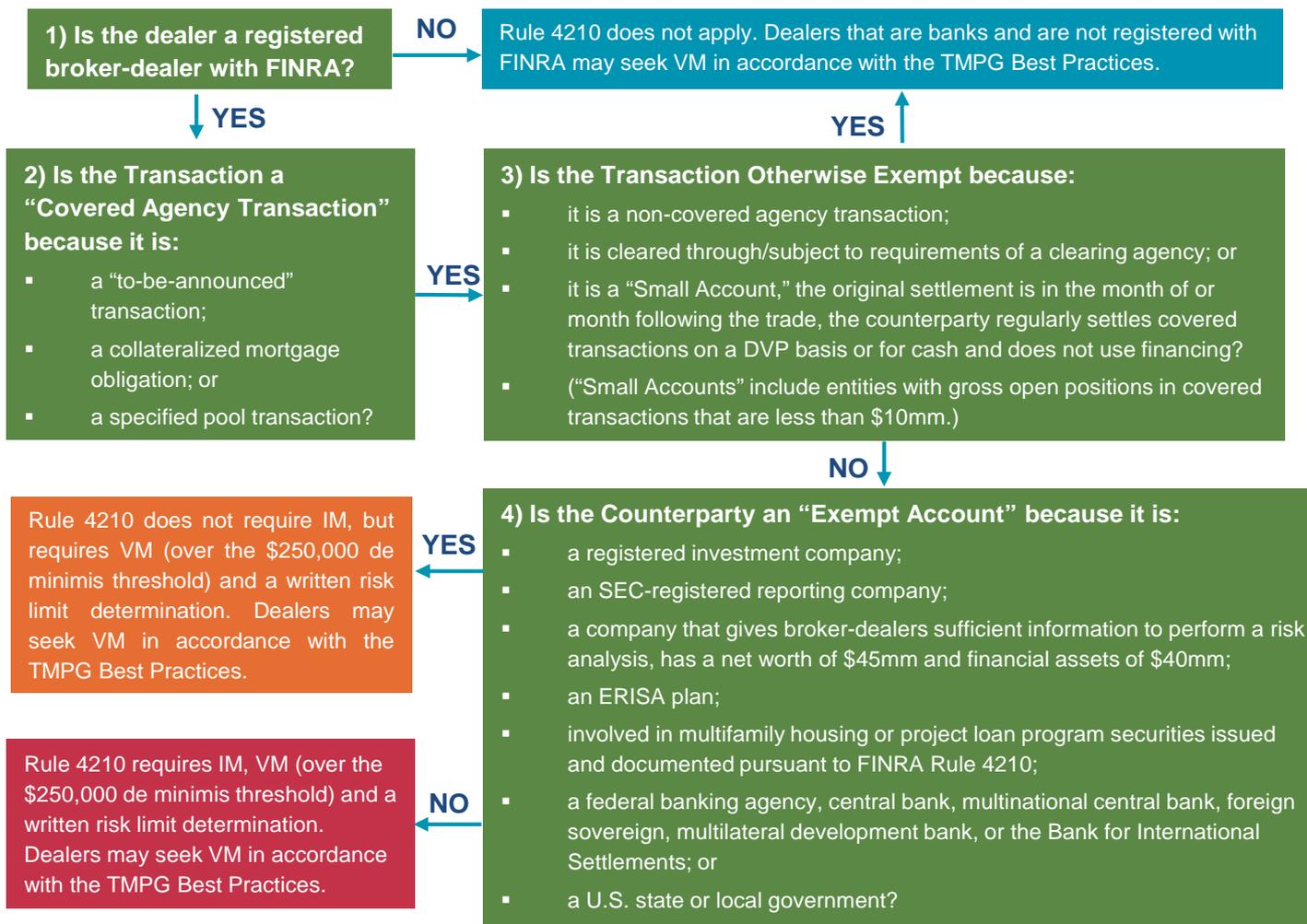


# FINRA RULE 4210 MARGIN OBLIGATIONS

- Why more margin requirements for MBS?
  - 2012 MSFTA:
    - Exchange of margin pursuant to the TMPG Best Practices applying to banks subject to regulation by the Federal Reserve
  - FINRA Rule 4210:
    - FINRA-member broker-dealers for Covered Agency Transactions with limited exceptions for Exempt Accounts
- Margin requirements:
  - Initial margin (unless an Exempt Account)
  - Variation margin (over the \$250,000 de minimis threshold)
    - Unlike the TMPG Best Practices, FINRA Rule 4210 only requires the collection of variation margin
    - Counterparties should consider bilateral margining
- **Effective date**: March 25, 2020



# FINRA RULE 4210 MARGIN OBLIGATIONS



# RECENT ISDA PROTOCOLS

- Benchmark Fallbacks
  - 2018 Benchmarks Supplement Protocol
  - New ISDA Protocol under development for IBORs
- Bail-in Protocol
- ISDA Resolution Stay
  - U.S. Resolution Stay vs. Other Country Protocols



# ELECTRONIC DOCUMENT NEGOTIATION

- ISDA Create
  - First module for Initial Margin Documentation launched January 2019
  - Additional modules being added, including Custody
- Standardization
  - ISDA Taxonomy and Clause Library
- Digitization





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