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2018 BOSTON INVESTMENT MANAGEMENT CONFERENCE – November 28, 2018

Derivatives Updates

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AGENDA

- ISDA 2018 U.S. Resolution Stay Protocol
- Brexit's Impact on the Derivatives Market
- 1940 Act Derivatives Rule Update

ISDA 2018 U.S. RESOLUTION STAY PROTOCOL

INTRODUCTION AND ROADMAP

- Overview of the U.S. Stay Regulations and the ISDA U.S. 2018 Resolution Stay Protocol (the "**Protocol**")
- How the Protocol fits into compliance with requirements of the U.S. Stay Regulations
- Timing expectations

OVERVIEW: U.S. STAY REGULATIONS

- In late 2017, the Federal Reserve, FDIC and OCC published final rules requiring U.S. global systemically important banks ("**GSIBs**"), their subsidiaries and U.S. operations of non-U.S. GSIBs ("**Covered Parties**") to ensure certain qualified financial contracts ("**QFCs**"):

  (1) Are subject to existing limits on the exercise of default rights by counterparties under the OLA and FDIA, and

  (2) Limit the ability of counterparties to exercise default rights related, directly or indirectly, to an affiliate of a Covered Party entering into insolvency proceedings

- Although most buy-side counterparties are not directly subject to the U.S. Stay Regulations, many of their sell-side counterparties are

OVERVIEW: ISDA 2018 U.S. RESOLUTION STAY PROTOCOL

- ISDA published the Protocol on July 31, 2018
- Compliance safe harbor under the U.S. Stay Regulations
- Stakes out middle ground between the Universal Protocol and the ISDA JMP, but with "sweeteners" for the buy-side

SCOPE OF QFCs

- Scope of agreements the Protocol applies to is consistent with the U.S. Stay Regulations
- Applies to a broad range of agreements that either restrict transfer from or provide default rights exercisable against Covered Parties, including:
  - Securities contracts (including mortgage loans and debt securities
  - Commodity contracts
  - Forward contracts
  - Repurchase agreements
  - Swap agreements
  - Master agreements, credit support agreements, and other credit enhancements

PART I: THE OPT-IN

- A party adhering to the protocol opts in to the U.S. Special Resolution Regime and to any special resolution regime covered by an applicable Jurisdictional Module
- The opt-in will apply both to QFCs where one party is not a U.S. entity and to QFCs between U.S. entities that do not designate the U.S. Special Resolution Regime as the governing law of the QFC
- For this reason, the Protocol will apply potentially to a far broader expanse of buy-side clients than previous protocols

PART II: LIMITATION ON CROSS-DEFAULT

- If a GSIB is fulfilling its obligations under a QFC and has not entered insolvency proceedings, but its affiliate becomes subject to an insolvency proceeding, then the GSIB's counterparty may not:
  - Exercise cross-default or termination rights related to that insolvency proceeding; or
  - Restrict the transfer of any GSIB guaranty of the applicable QFC

A PATH WELL CHOSEN: THE PROTOCOL OR BILATERAL NEGOTIATION

- Whether adherence to the Protocol constitutes the better option depends on a party's particular circumstances
  - Protocol provides beneficial creditor protections relating to affiliate cross-default
  - Once a party adheres to the Protocol, unless it uses the 'some but not all' method of adherence by an investment manager as agent for its funds, the Protocol will apply to all QFCs with all Covered Parties that also adhere to the Protocol
  - Unlike other ISDA protocols, the terms of the Protocol cannot be amended by bilateral agreement between adhering parties
- Buy-side counterparties will need to weigh the greater cross-default protections for creditors, the universality of the application of the Protocol and any operational and compliance benefits/burdens with adherence to the Protocol in the context of their own business and operations

ENHANCED CREDITOR PROTECTIONS

- Certain creditor protections are available ONLY by adhering to the Protocol
  - Performance default rights and unrelated default rights
  - Affiliate credit enhancement providers
  - Lower burden of proof for some default rights
  - Limitations on counterparty cross-default rights also apply in non-U.S. insolvency proceedings

COMPLIANCE DATES

Entities Subject to the QFC Rules		
Entity Type	**Entity Definition**	**Compliance Date**
Covered Entities	• U.S. top-tier bank holding companies which are GSIBs; • The subsidiaries of any U.S. GSIB; and • The U.S. operations of any foreign GSIB	January 1, 2019
Financial Counterparties	A wide range of regulated financial institutions, including lenders, broker-dealers, swap dealers, futures commission merchants, investment advisers, investment companies, commodity pool operators, commodity trading advisers, private funds and similar entities	**July 1, 2019**
Small Financial Institutions	Insured banks, insured savings associations, farm credit system institutions, and credit unions with assets of $10 billion or less	January 1, 2020

TRENDS & FEEDBACK FROM INDUSTRY PARTICIPANTS

- We expect most buy-side counterparties will adhere to the Protocol given beneficial creditor protections and operational burden of bilateral amendments
- Confusion among buy-side and sell-side about compliance dates
- Dealers are currently urging their counterparties to adhere by January 1, 2019

WHEN TO AMEND

- Some dealers have provided notice to buy-side participants that if they do not comply with the Protocol or bilaterally negotiate amendments by January 1, 2019, trading may be disrupted
  - Certain of these dealers are of the view the rules contain some ambiguity with respect to the applicable compliance date for buy-side participants
- While we do not consider it likely that dealers will follow through on threats to cut off trading, you may want to consider a process to protect your trading in the event that they one or more dealers follow through on these threats

RECOMMENDED COURSE OF ACTION

- **Between now and December 10th**: Confirm which funds need to adhere to the Protocol
- **Week of December 10th**: Draft and execute Adherence Letters
- **December 26-31st**: Submit Adherence Letters; if (i) regulatory relief is not granted and (ii) dealers continue to assert that trading could be disrupted

ADHERENCE PROCESS

- You adhere to the Protocol by executing and submitting an Adherence Letter
- Four methods of adherence
  - Single entity adherence
  - Adhering as an agent on behalf of all funds
  - Adhering as an agent on behalf of some, but not all funds
  - Adhering as an agent on behalf of all funds except certain funds

BREXIT'S IMPACT ON THE DERIVATIVES MARKET

NO DEAL BREXIT: DODD-FRANK

- Clearing between US and UK entities could be affected if the UK loses the benefit of substituted compliance through equivalence decisions
- Because the US and UK have no equivalence decisions regarding clearing, it is unclear whether, upon exit day, a US entity clearing on a UK CCP can do so in compliance with the Dodd-Frank Act rather than UK legislation, or vice versa

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NO DEAL BREXIT: EUROPEAN MARKET INFRASTRUCTURE REGULATION (EMIR)

- UK-based banks would no longer be subject to EMIR
- Existing exemptions for transactions between UK and EU affiliated entities will cease to apply, meaning that EU counterparties contracting with UK affiliates may be required to clear contracts and exchange initial and variation margin
- Exchange-traded derivatives executed on UK regulated markets will be treated as OTC derivatives for purposes of determining NFC+ status
  - EU entities classified as NFC-s may become NFC+s after including their UK exchange-traded derivatives in the clearing threshold calculation

NO DEAL BREXIT: BANK RECOVERY AND RESOLUTION DIRECTIVE (BRRD)

- The UK would be considered a “third country” for purposes of BRRD
- This would require EEA banks and investment firms to include contractual recognition of bail-in clauses into non-EEA law governed contracts (including English law-governed ISDA Master Agreements) pursuant to Article 55 of BRRD

MITIGATION

- Even if the EU and UK do not sign the withdrawal agreement before March 29, 2019, regulators may still take mitigating actions to prevent the effects of a no deal Brexit
- Firms should be following any mitigating steps taken by regulators closely to avoid under-compliance or over-compliance with any regulatory regimes

1940 Act Derivatives Rule Update

1940 ACT DERIVATIVES RULE

- The Division of Investment Management is expected to recommend that the SEC re-propose the rule
  - Expected in Q2 2019
- As a recap, the SEC originally proposed Rule 18f-4 under the 1940 Act on December 11, 2015
- The rule has 3 primary elements
  - Explicit limitations on portfolio leverage
  - Asset segregation requirements
  - Derivatives risk oversight by fund management and the fund's board

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