

The logo for K&L GATES is displayed in white, bold, sans-serif capital letters on a dark blue rectangular background. The background of the entire slide features a complex financial data visualization with a world map, various line and bar charts, and scattered numerical values in shades of blue and white.

K&L GATES

Session V

Derivatives Updates

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AGENDA

- Global Derivatives Regulatory Update
 - Margin for Uncleared Swaps
 - EMIR REFIT
 - FINRA Rule 4210 Margin Requirements
- CFTC Regulatory Developments
 - NFA Compliance Rule 2-9
 - NFA Compliance Rule 2-29
 - CFTC Relief: Separate Accounts for Asset Managers
 - Proposed CPO/CTA Rule Changes at CFTC
 - CFTC Thematic Reviews of CPOs and CTAs





Global Derivatives Regulatory Update: Margin for Uncleared Swaps



MARGIN FOR UNCLEARED SWAPS

- 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.)

- Remaining advocacy and implementation issues:
 - AANA scoping
 - SIFMA AMG Client Outreach Letter
 - IM threshold calculations – request for annual measurements
 - MMF issues

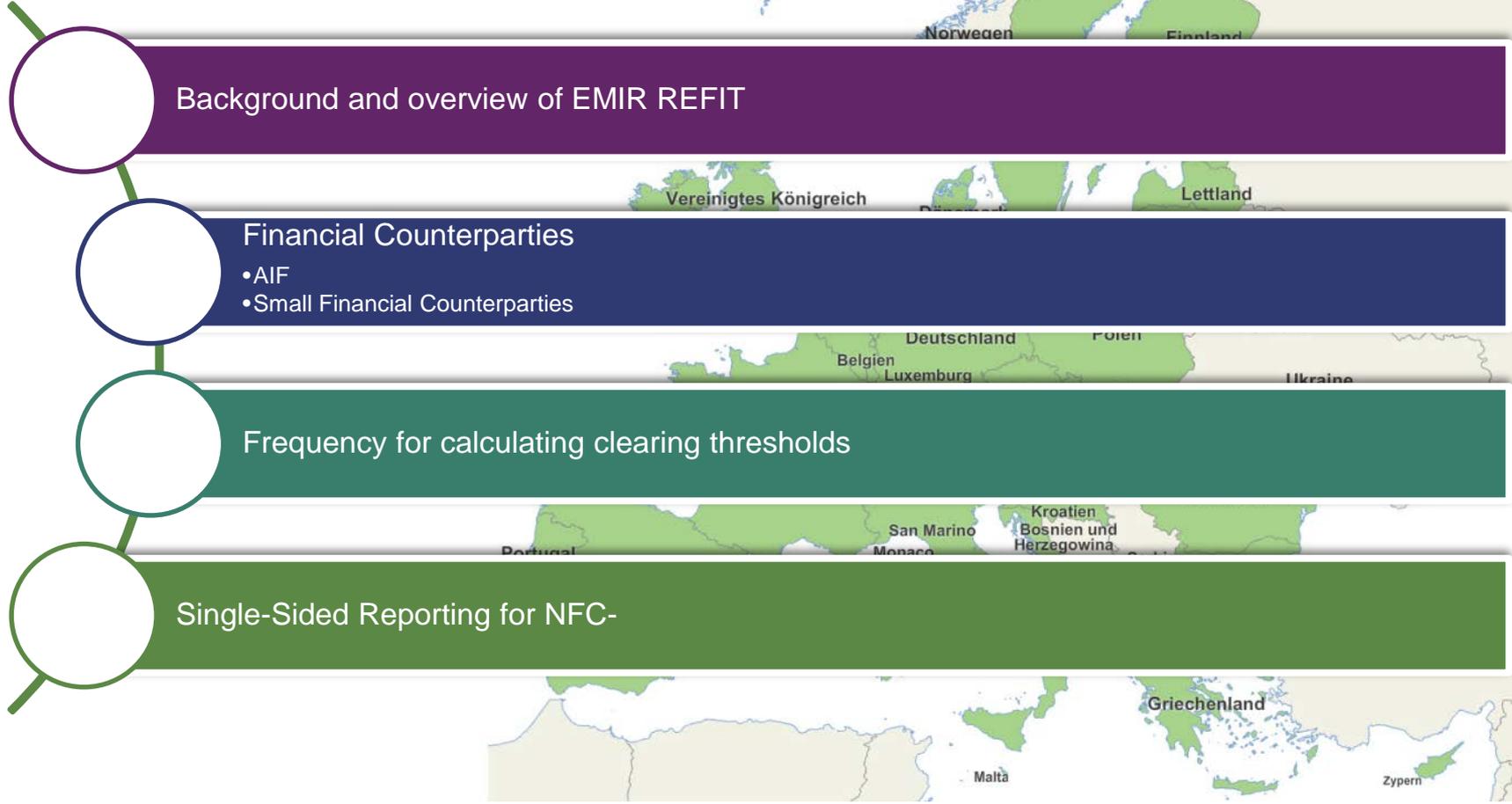




Global Derivatives Regulatory Update: EMIR REFIT



OVERVIEW



EMIR REFIT BACKGROUND

EMIR came into force on August 16, 2012

In accordance with EMIR, the EU Commission was required to review EMIR and provide a report by August 17, 2015

In May 2017, the EU Commission provided a draft for EMIR modifications

- AIF should always be viewed as FC

EMIR REFIT came into effect on June 17, 2019

Review and report back to EU Commission before June 18, 2024



OVERVIEW OF THE KEY CHANGES

Reporting

- **Single-sided reporting for trades between FC and NFC-**
- No reporting obligation for intra-group transaction
- Responsibility of AIFM and UCITS management company

Clearing

- **Yearly calculation of clearing threshold**
- **Expansion of definition of FC, especially with regard to AIFs**
- **Small Financial Counterparty (SFC)**
- NFC clearing duty only with regard to types of derivatives over clearing thresholds
- Extension of exemption from clearing obligation for pension funds
- No frontloading
- FRAND – Fair, reasonable, non-discriminatory and transparent terms

Risk Mitigation

- Exception for physically settled FX forwards and swaps
- To be limited to transactions between systemically important institutions

FINANCIAL COUNTERPARTIES: AIF

EMIR

- (1) AIF managed by
- (2) EU-domiciled or registered AIFM

EMIR REFIT

- (1) AIF formed in the EU
- OR
- (2) Managed by an AIFM located in the EU

NFC: A non-EU AIF managed by a non-EU AIFM



FINANCIAL COUNTERPARTIES: SFC

For Counterparties with Low Trading Volume

- High cost for clearing members
- Operational burdens

New Article 4a EMIR as Exception from Clearing Obligation

- Calculation of clearing threshold every 12 months
- Clearing threshold calculation includes all derivatives (no exceptions for hedging)
- Calculated at fund level
- If no calculation is made, must report to ESMA and relevant national regulator

CALCULATION OF CLEARING THRESHOLD

Calculation:

- Only every 12 months rolling 30 days
- Obligation to make calculation came into effect June 17, 2019

When no calculation made:

- Clearing obligation for ALL derivatives classes beginning October 18, 2019
- Must report to ESMA and the relevant national regulator

Clearing Threshold

Above the clearing threshold:

- Clearing obligation beginning October 18, 2019
- Must report to ESMA and the relevant national regulator
- Can notify if activity falls below the threshold

Below the clearing threshold:

- No further obligations



SINGLE-SIDED REPORTING FOR NFC-

Effective from June 18,
2020

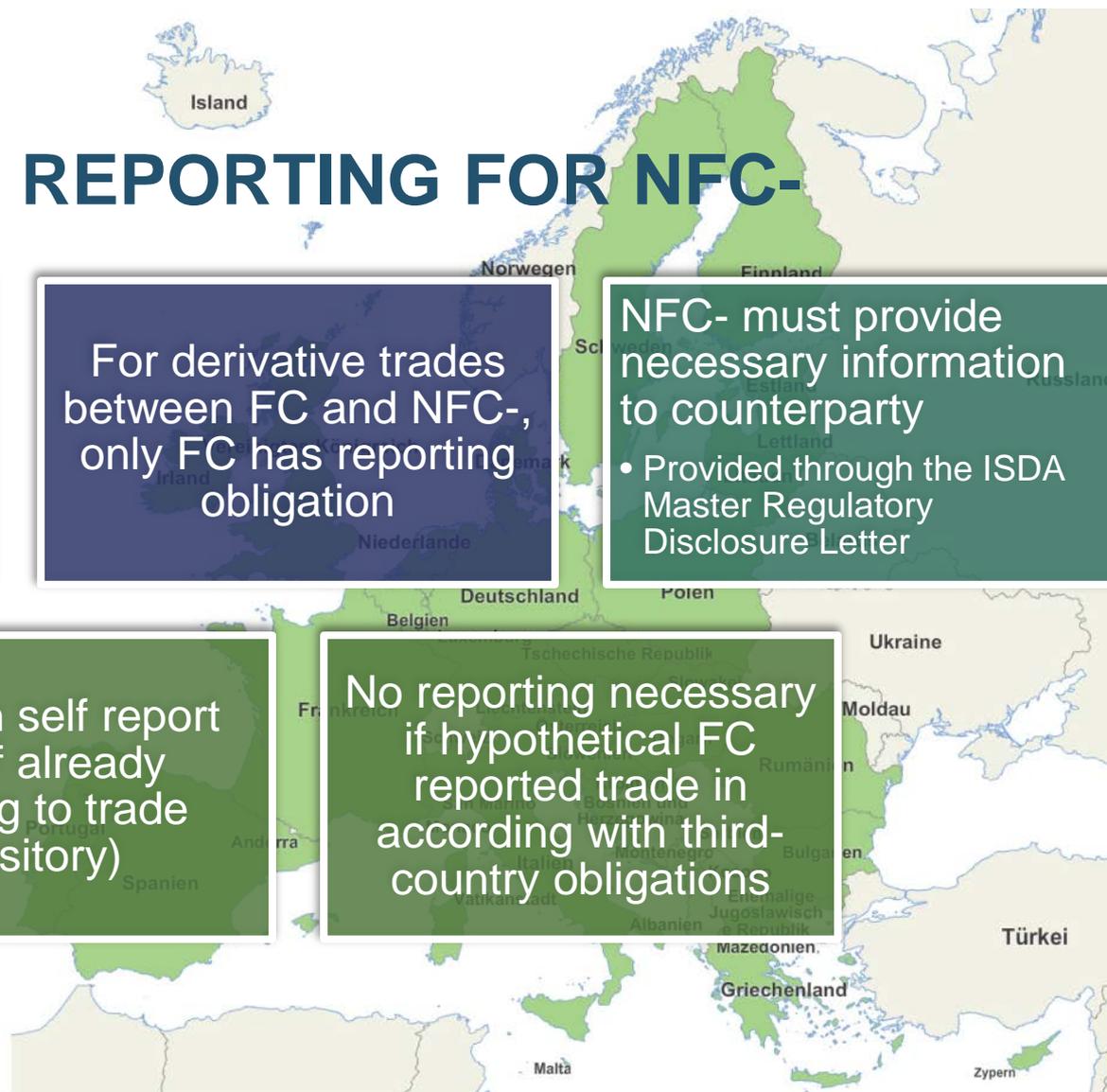
For derivative trades
between FC and NFC-,
only FC has reporting
obligation

NFC- must provide
necessary information
to counterparty

- Provided through the ISDA
Master Regulatory
Disclosure Letter

NFC- can self report
(e.g., if already
reporting to trade
repository)

No reporting necessary
if hypothetical FC
reported trade in
according with third-
country obligations





Global Derivatives Regulatory Update: FINRA Rule 4210 Margin Requirements

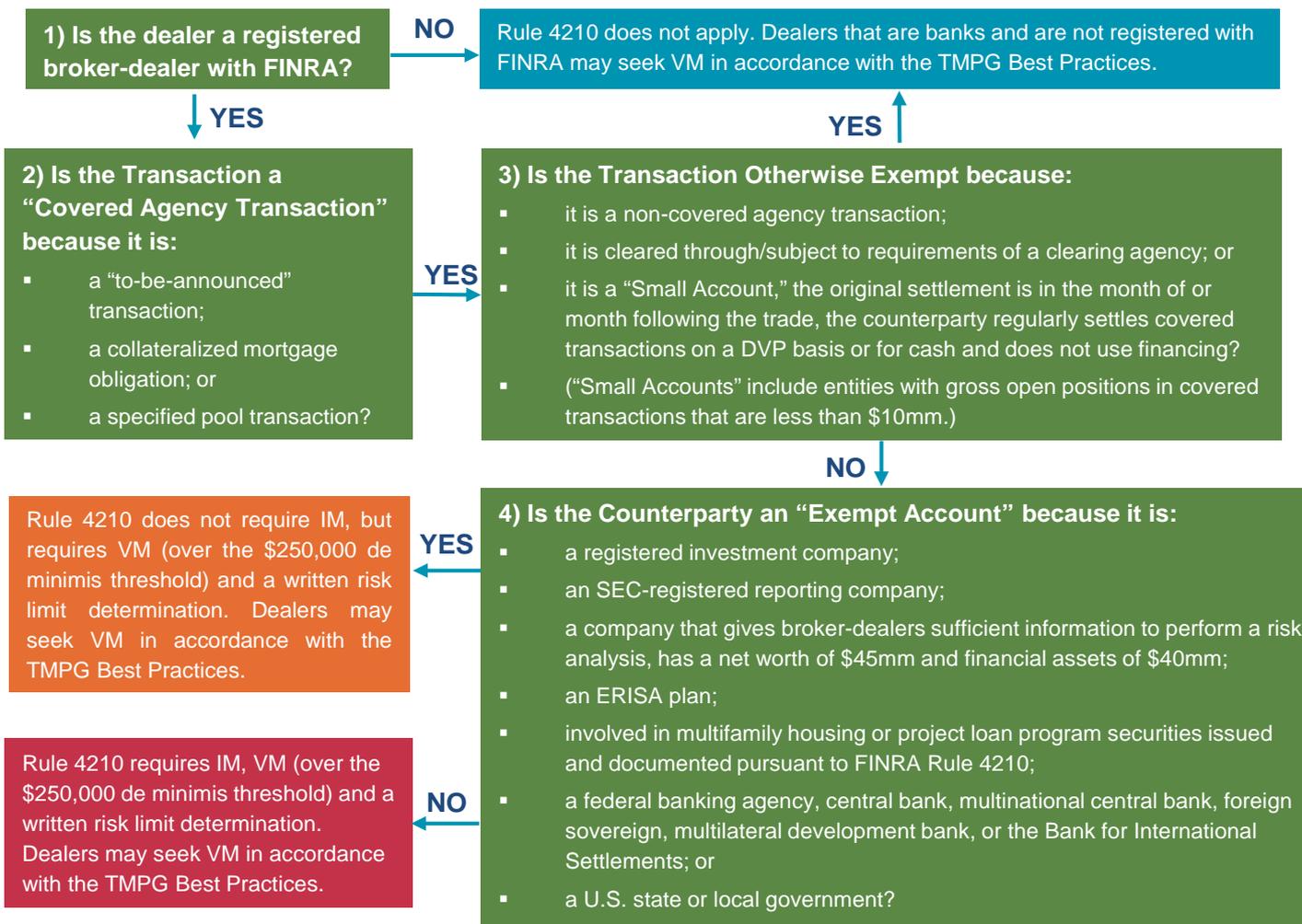


FINRA RULE 4210 MARGIN OBLIGATIONS

- 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





CFTC Regulatory Developments



CPO INTERNAL CONTROLS SYSTEM

- NFA Compliance Rule 2-9 provides that Commodity Pool Operators (“CPO”) diligently supervise its employees and agents in all aspects of their commodity interest activities
- Per NFA Interpretive Notice 9074 (CPO Internal Controls System), NFA requires that a CPO “implement an internal controls system that is designed to deter fraudulent activity by employees, management, and third parties in order to address the safety of customer funds and provide reasonable assurance that a CPO’s commodity pool’s financial reports are reliable and that the Member is in compliance with all CFTC and NFA requirements”
- A CPO must demonstrate compliance with NFA Compliance Rule 2-9 and NFA Interpretive Notice 9074 through its internal controls system
 - Means of compliance include the CPO’s policies and procedures and related training to its employees
- A CPOs ongoing compliance program should be designed to detect and remediate issues of noncompliance, in order to demonstrate compliance with applicable policies and procedures



INTERNAL CONTROLS - PRINCIPLES

A CPO's internal controls framework must demonstrate compliance with the following principles set forth in NFA Interpretive Notice 9074, as follows:

- **Separation of Duties**
 - Avoid a scenario where a single employee is in a position to carry out and conceal errors or fraud or have control over any two phases of a transaction or operation.
- **Risk Assessment**
 - Control objectives relate, in part, to compliance with the requirements related to pool subscriptions, redemptions and pool transfers and provides an examination of the controls in place to safeguard participant and pool assets.
- **Recordkeeping**
 - Maintain an internal controls report and other documentation that demonstrate compliance with the internal controls systems



NFA COMPLIANCE RULE 2-29

- NFA Compliance Rule 2-29 establishes standards for “promotional material” of CPOs and CTAs
- NFA recently proposed updates to codify staff positions on net performance
- Inconsistencies with SEC staff interpretations of Advisers Act rule 206(4)-1:
 - Presentation of gross performance in one-on-one presentations
 - Side-by-side presentation of gross and net performance with equal prominence
 - Exclusion of custody and administrative expenses from CTA net returns



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



STAFF STATEMENT OF SEPARATELY MANAGED ACCOUNTS

- The Directors of DSIO and DCR reaffirmed CFTC Letter 19-17 and stated their expectation that market participants comply with CFTC requirements. See 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)



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



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
 - 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
 - (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



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



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