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A Derivatives Trader's Compliance Checklist

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Law360, New York (January 31, 2017, 12:44 PM EST) -- The first two months of 2017 present several important new regulatory deadlines potentially affecting all asset managers that trade derivatives subject to U.S. regulation. Certain deadlines potentially will apply to all derivatives traders whether or not the asset manager is a member of the National Futures Association and registered with the U.S. Commodity Futures Trading Commission as a commodity pool operator (CPO) or commodity trading advisor (CTA).

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This article focuses on specific new deadlines and several developments implicating regulations already in effect, which will require advance planning (including business-level input) and, in some cases, could cause trading disruptions if deadlines are not met.

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Absent CFTC or staff relief, many market participants will need to address documentation implementation and changes required to comply with the uncleared swap variation margin rules by March 1, 2017, and the position limits disaggregation notice filing requirement by Feb. 14, 2017. We understand that industry groups have requested temporary relief from both rules. Further, CFTC Acting Chairman J. Christopher Giancarlo suggested in a speech on Jan. 18, 2017, that the CFTC might consider easing the compliance burden under the variation margin rules (e.g., by delaying the compliance date for posting variation margin for some market participants). However, as of the date of this article, no solution has been announced.

Uncleared Swap Variation Margin — Compliance Date: March 1, 2017

Regulatory Background

As of March 1, 2017, as a result of the application of the uncleared swap margin requirements of the CFTC and prudential regulators[1] (U.S. margin requirements), any "financial end user" (including many entity types ranging from large financial institutions to asset managers and pooled investment vehicles) will be required to exchange variation margin for its transactions in:

- Uncleared swaps with CFTC-registered swap dealers and major swap participants for which there is no prudential regulator; and

- Uncleared swaps and uncleared security-based swaps with registered swap dealers, major swap participants, security-based swap dealers and major security-based swap participants that are regulated by a prudential regulator.

Further, as of March 1, 2017, there will no longer be a notional amount threshold for the application of the U.S. variation margin requirements. However, the U.S. initial margin requirements will continue to be phased in, according to a schedule based on the average daily aggregate outstanding notional amount of uncleared swaps, security-based swaps, foreign exchange forwards and foreign exchange swaps of a party and its affiliates,[2] calculated as set forth in the U.S. margin requirements (notional amount).[3]

The U.S. margin requirements generally apply to transactions with any financial end user that is a “U.S. person” as defined under the applicable rules.[4] Financial end-user entities that are not U.S. persons may be required indirectly to comply with U.S. margin requirements because they face certain counterparties.[5]

Similar rules are being implemented and will concurrently come into effect in the near future, under regulatory technical standards adopted by the European Commission and in other jurisdictions.

New Documentation Requirements

Dealers have been reaching out to their financial end-user counterparties to request that the latter: (1) complete self-disclosure documents detailing their jurisdiction and entity type, to determine what country’s rules will apply to their transactions; and (2) amend or put into place new collateral arrangements that comply with the applicable requirements.

Many participants in transactions in certain covered instruments (e.g., nondeliverable foreign exchange forwards) previously did not exchange margin, and therefore counterparties may not have credit support documentation in place. Dealers will either: require such counterparties to agree to new credit support documentation (i.e., ISDA Credit Support Annex (CSA)) to comply with the U.S. variation margin requirements prior to March 1, or decline to enter new trades starting on March 1.

Financial end users’ dealers for most other swaps and security-based swaps transactions will either require their counterparties to amend their credit support documentation to comply with the variation margin requirements, or decline to enter new trades starting on March 1.

Key terms that may need to be modified for compliance include: (1) collateral schedules and haircuts on collateral; (2) next-business-day margin transfer timing; (3) minimum transfer amounts; and (4) custodial provisions for parties using third-party custodians to hold margin (e.g., investment companies registered under the Investment Company Act of 1940).

The new documentation can be put in place through negotiation of bilateral agreements or by adherence to the ISDA 2016 Variation Margin Protocol. It may be a lengthy process to identify the status of all of an asset manager’s clients, as well as to negotiate amendments to credit support documentation to comply with applicable requirements or election of variables within the ISDA protocol. This process may involve business-level judgment calls. Asset managers that have not

been contacted by their dealers therefore should proactively reach out to their dealers to initiate the documentation process, or they otherwise may risk trading disruptions or potentially be unable to negotiate key terms prior to putting new documentation in place.

Position Limit Disaggregation Notice Filings — Compliance Date: Feb. 14, 2017

Historically, in certain circumstances market participants could disaggregate commodity interest positions for purposes of compliance with CFTC and exchange-set position limits, without providing notice to the CFTC regarding such disaggregation. However, effective Feb. 14, 2017, entities wishing to disaggregate positions will be required to file a notice with the CFTC in many of these instances.

Importantly, the notice requirement does not provide for grandfathering of legacy exemptions. Accordingly — and absent any further CFTC guidance — any entity currently relying, or expecting to rely, on one of the below exemptions will need to make a filing in order to continue relying on such exemption:

- A limited partner, shareholder or other pool participant that is a principal or affiliate of the operator of the pooled account under CFTC Rule 150.4(b)(1)(ii) (but no notice is required for certain other types of pool participants);
- Positions where there is ownership of greater than 10 percent in an owned entity under CFTC Rule 150.4(b)(2) (a new exemption, applicable as of Feb. 14, 2017);
- Accounts carried by an independent account controller under CFTC Rule 150.4(b)(4); and
- Positions of an owned entity where sharing of information in connection with such aggregation creates a reasonable risk that either the owner or owned entity could violate applicable law or rules under CFTC Rule 150.4(b)(7).

Each of the exemptions are subject to various conditions with which an entity must comply in order to seek to rely on the exemption. Rule 150.4(c) provides that the CFTC can issue a call requiring any person claiming an exemption to provide the CFTC with information demonstrating that the person meets the requirements of the exemption.

A notice filed under Rule 150.4(c) will be effective: (1) on submission of the notice; or (2) retroactively as of the date of an acquisition, if the notice of an exemption under Rule 150.4(b)(2) is filed within a 60-day period after the acquisition of ownership of greater than 10 percent in an owned entity. Further, if a person is eligible for one of the above aggregation exemptions, a failure to timely file a notice will not constitute a violation of the aggregation rule or CFTC position limits if such notice is filed no later than five business days after the person is aware, or should be aware, that the notice has not been timely filed.

In the event of any material change to the required information provided in a previously filed notice, an amended or updated notice must promptly be filed detailing the change.

While the CFTC has not yet specified the format and electronic data transmission procedures for filing the notice with the CFTC, new CFTC Rule 150.4(c) provides that the notice must include: (1) a description of the relevant circumstances that warrant disaggregation; and (2) a statement of a senior officer of the entity certifying that the conditions for reliance on the applicable exemption provision have been met.

Entities considering their compliance with CFTC notice requirements should also consider whether parallel applications for owned entity and other exemptions should be submitted to the exchanges on which such entities trade, in accordance with applicable exchange rules (e.g., CME Rule 559.E or ICE Rule 6.12, adopted in March 2016).

CFTC Form CPO-PQR/NFA Form PQR: Reporting of Parallel Managed Account Information on Pool-Level Questions and Intraquarter Monthly Rate of Return Reporting for All Pools — Compliance Dates: March 1, 2017, for Large CPOs and March 30, 2017, for Mid-Size and Small CPOs

Beginning with the 2016 fourth-quarter filing, registered CPOs must include parallel managed account information for applicable pool-level questions on CFTC Form CPO-PQR.

As soon as possible, registered CPOs should review whether they consider themselves to operate parallel managed accounts. If so, those CPOs need to review the questions they must answer in CFTC Form CPO-PQR/NFA Form PQR to determine the questions for which they will need to provide parallel managed account information, as not all questions are in scope.[6] Finally, affected CPOs must make sure they have the necessary data for the questions in scope — this may involve working ahead of time with the fund administrator or internal accounting department.

Beginning with the 2016 fourth-quarter filing, the CFTC and NFA will no longer accept an entry of "NT" for the first two months of each quarter (interquarter months) for pools that do not calculate a monthly rate of return.

All CPOs will need to report a monthly rate of return for each pool for each month of the reporting period. CPOs to pools that do not calculate monthly rates of return in the normal course of business (most likely those that are operating private equity funds) must plan ahead to determine how they will conduct the calculations, which the CFTC staff has stated may be estimates provided that such estimates are based on reasonable methodologies. CPOs that were previously not reporting interquarter monthly rates of return do not need to recalculate and report data for previous quarters.

U.S. Clearing Mandate for Certain Interest Rate Swaps Denominated in Non-U.S. Currencies

On Dec. 13, 2016, the CFTC began requiring the central clearing of seven interest rate swaps denominated in currencies other than U.S. dollars where those swaps are already subject to a clearing mandate in another jurisdiction.[7] Further, the CFTC will require the central clearing of several additional non-U.S. dollar denominated interest rate swaps, upon the earlier of: 60 days after those swaps become subject to clearing in another jurisdiction, or Oct. 15, 2018 (two years following publication of the CFTC final rulemaking in the Federal Register).[8]

This requirement applies to persons subject to the U.S. Dodd-Frank Act swaps rules. Entities trading

one or more of the enumerated swaps will need to confirm they have appropriate clearing documentation in place prior to the respective mandated central clearing dates.

NFA Forms PQR and PR: Reporting of Certain CPO and CTA Financial Ratios — Compliance Dates: Aug. 29, 2017, for CPOs and Aug. 16, 2017, for CTAs

For NFA Form PQR and NFA Form PR quarterly filings, beginning with the quarter ending on June 30, 2017, all member CPOs/CTAs required to make these filings will be required to disclose information relating to two additional ratios: (1) the CPO/CTA's current assets/current liabilities ratio as of the reporting quarter end, which provides a measure of a firm's liquidity; and (2) the CPO/CTA's total revenue/total expenses ratio reflecting the total revenue earned and total expenses incurred during the prior 12 months, which measures a firm's operating margin. NFA intends to use the new ratios to collect information about the financial condition of member CPOs/CTAs and identify firms that could be facing financial difficulties.

The ratios must be computed using the accrual method of accounting and in accordance with generally accepted accounting principles (GAAP) or another internationally recognized accounting standard, in all cases, consistently applied.

CPOs and CTAs that have a parent company may elect to report these ratios at the parent-company level, but will need to indicate in the relevant form at which level the reporting is taking place.

CPOs and CTAs need to plan ahead to determine the level in their structure at which they will report, if applicable. Further, CPOs and CTAs need to make sure they have the necessary data to compute the ratios; this may involve coordination with the internal accounting department with sufficient time prior to the filing.

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[1] The prudential regulators are the Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corp., Farm Credit Administration and Federal Housing Finance Agency.

[2] Market participants are required to account for the trading activity of their affiliates, using an accounting-based definition of the term "affiliate" that considers whether: (1) the entities are consolidated in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP), the International Financial Reporting Standards or other similar standards, (2) the entities are each consolidated with another entity in financial statements prepared in accordance with such accounting principles or standards; or (3) if consolidation in (1) or (2) above would have applied if the company were subject to such principles or standards. The prudential regulators also are able to designate an entity as an affiliate based on the respective agency's conclusion that the company either provides significant support to, or is materially subject to the risks of losses of, the other company.

[3] The implementation schedule for the U.S. initial margin requirements is:

- Sept. 1, 2016, if the notional amount for each party (and its affiliates) exceeds $3 trillion;
- Sept. 1, 2017, if the notional amount for each party (and its affiliates) exceeds $2.25 trillion;
- Sept. 1, 2018, if the notional amount for each party (and its affiliates) exceeds $1.5 trillion;
- Sept. 1, 2019, if the notional amount for each party (and its affiliates) exceeds $75 billion; and
- Sept. 1, 2020, for all other parties.

[4] Note, however, that the U.S. initial margin requirements will apply only to transactions with a financial end user if the financial end user and its affiliates have "material swaps exposure" (i.e., notional amount over $8 billion). Further note that collection or posting of initial margin is not required if the aggregate unmargined exposure either to or from a covered swap entity's counterparty remains below $50 million.

[5] Very generally, currently U.S. margin requirements subject a non-U.S. entity dealing in swaps to U.S. margin requirements if: (1) its financial statements are consolidated with that of a U.S. ultimate parent entity under applicable accounting rules (foreign consolidated subsidiary); (2) it is a non-U.S. person CFTC- or U.S. Securities and Exchange Commission-registered swap dealer or security-based swap dealer or major swap participant or major security-based swap participant whose obligations under the trade are guaranteed by a U.S. person; or (3) it is a non-U.S. branch of a U.S. person entity. The CFTC and/or prudential regulators may issue a comparability determination with respect to the local margin requirements that would enable certain parties to rely on substituted compliance with the local margin requirements.

[6] For example, the NFA states in the filing template it provides on its website that relationships for parallel managed accounts do not need to be reported.

[7] The interest rate swaps for which there is already a clearing mandate in another jurisdiction, and therefore must be cleared if traded by U.S. persons as of Dec. 13, 2016, are as follows:

- AUD-denominated fixed to floating rate swaps
- MXN-denominated fixed to floating rate swaps
- AUD-denominated basis swaps
- EUR-denominated overnight index swaps (OIS) (2-3 year term)
- GBP-denominated OIS (2-3 year term)
- USD-denominated OIS (2-3 year term)
- AUD-denominated OIS

[8] The additional non-U.S. dollar denominated interest rate swaps subject to the rulemaking, and the date they are mandated to be centrally cleared if traded by U.S. persons, are as follows:

- NOK-denominated fixed to floating rate swaps: April 10, 2017
- PLN-denominated fixed to floating rate swaps: April 10, 2017
- SEK-denominated fixed to floating rate swaps: April 10, 2017
- NOK-denominated forward rate agreements (FRAs): April 10, 2017
- PLN-denominated FRAs: April 10, 2017

- SEK-denominated FRAs: April 10, 2017
- CAD-denominated fixed to floating rate swaps: July 10, 2017
- CAD-denominated OIS: July 10, 2017
- CHF-denominated fixed to floating rate interest rate swaps: Oct. 15, 2018
- SGD-denominated fixed to floating rate interest rate swaps: Oct. 15, 2018

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