Katten
Katten Muchin Rosenman LLP

Corporate & Financial Weekly Digest

November 2, 2018 Volume XIII, Issue 43

DERIVATIVES

See "CFTC Issues No-Action Relief Regarding FCM's Deposit of Customer-Owned Securities" and "CFTC's Office of the Chief Economist Issues Report on Initial Margin Phase 5" in the CFTC section. Also see "Banking Regulators Propose Revised Methodology for Calculating Derivatives Exposure" in the Banking section.

SEC Issues Statement on Swap Business Conduct Rules

On October 31, the Securities and Exchange Commission took an unusual additional step towards implementing its rules for security-based swaps (SBS) by issuing a document entitled "Commission Statement on Certain Provisions of Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants." The novelty of the Statement is that it amounts to a promise of five years of future no-action relief from enforcement after implementation of the SBS rules for any SBS Entity (as defined below) that chooses to follow certain Commodity Futures Trading Commission external business conduct rules for its SBS trading instead of complying with the SEC's analogous (but slightly different) business conduct rules for SBS. An SBS Entity is any entity that is registered with the SEC as either (1) an SBS dealer or (2) a major SBS participant.

The Statement applies only to the particular SBS business conduct rules set out in 15Fh-1 to 15Fh-6 under the Securities Exchange Act of 1934, and only to the particular extent specified in the Statement.

The Statement is an odd, time-limited way to achieve harmonization of CFTC and SEC swap rules. The position represented by the Statement will, however, be particularly helpful in alleviating (albeit temporarily) the compliance burdens faced by an entity that becomes dual registered as both a swap dealer and an SBS dealer when the SBS rules come into effect.

The Press Release concerning the Statement is available here.

The Statement itself is available here.

CFTC

CFTC Issues No-Action Relief Regarding FCM's Deposit of Customer-Owned Securities

On October 31, the Division of Swap Dealer and Intermediary Oversight (DSIO) of the Commodity Futures Trading Commission issued Letter No. 18-26 to provide continuing relief to a futures commission merchant (FCM) from certain requirements regarding the holding of customer-owned securities as margin for trading on foreign futures and foreign options markets. This letter supersedes CFTC Letter No. 16-88 and was issued to address certain changes in European law with regard to the clearing of positions of clearing members' indirect clients.

As reported in the April 14, 2017, edition of the *Corporate and Financial Weekly Digest* covering Letter No. 16-88, European Union central counterparty (CCP) rules generally require a clearing member to have (1) sole and legal beneficial ownership in any securities posted with the EU CCP as margin; or (2) have the customer's consent to treat such securities as if it had such ownership. Such rules are inconsistent with CFTC Regulation 30.7, which provides that an FCM may not by contract or otherwise waive any of the protections afforded customer funds under the laws of the foreign jurisdiction. Therefore, Regulation 30.7 would not permit an FCM to (1) transfer legal and beneficial ownership of customer-owned securities; or (2) grant an affiliate the right to reuse such securities (which would constitute a transfer of legal title of the securities at the time such right of reuse is exercised). Notwithstanding this inconsistency, Letter No. 16-88 authorized the FCM to deposit customer-owned securities with a UK CCP, subject to a number of conditions, including a requirement to hold such customer-owned securities in an individual segregated account (ISA) established in accordance with the European Market Infrastructure Regulation (EMIR).

With the implementation of the requirements governing the clearing of positions of clearing members' indirect clients set out in the Markets in Financial Instruments Regulation and the Regulatory Technical Standards on Indirect Clearing, CCPs have generally elected not to offer ISAs for the accounts of indirect clients. Instead, they are offering so-called gross omnibus segregated accounts (GOSAs), which are designed to provide protections that are of "equivalent effect" to ISAs.

Based upon the representations set out in the request for a no-action position, including the representation that the FCM would maintain customer-owned securities in a GOSA, DSIO determined that continued no-action relief would be appropriate.

CFTC Staff Letter 16-88 is available here.

CFTC Staff Letter 18-26 is available here.

CFTC's Office of the Chief Economist Issues Report on Initial Margin Phase 5

On October 31, the Commodity Futures Trading Commission's Office of the Chief Economist issued a report on "Phase 5" of the uncleared margin rules (UMR). The purpose of the report is to provide a guide to regulators in their responses to requests for relief from various industry representatives.

The UMR mandate that registered swap dealers exchange initial margin (IM) on trades with other swap dealers and financial end-users. The rules have been phased in, beginning with those entities having the highest aggregate daily average of notional amount swaps (AANA) over June, July and August of the previous year. With the exception of swaps with commercial end-users, all swaps are counted towards AANA, including swaps that are exempt from IM. The last two phases, "Phase 4" and "Phase 5," are scheduled to take effect September 1 of 2019 and 2020, respectively. Phase 5 will capture entities with AANA between $8 billion and $750 billion.

Although Phases 1 through 4 are anticipated to capture just over 40 entities, Phase 5 could bring an additional 700 entities into the scope of the UMR. In light of the strain that this large increase in covered entities would place on their resources, industry representatives have requested various forms of relief from the regulators, noting, among other things, that in light of the comparatively small size of their swaps positions, the Phase 5 entities would pose little systemic risk. One of these requests, from a group of trade associations, has been sent to several regulators and seeks to have the Phase 5 threshold increased from $8 billion to $100 billion.

The report provides regulators with empirical data to guide their decision making, while reviewing these requests for relief, but makes no recommendations based upon its findings.

The Report is available here.

The request for relief is available here.

DIGITAL ASSETS AND VIRTUAL CURRENCIES

See "Cryptoassets Taskforce Publishes Final Report" in the UK/Brexit section.

BANKING

Banking Regulators Propose Revised Methodology for Calculating Derivatives Exposure

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (the agencies) are inviting public comment on a proposal that would implement a new approach for calculating the exposure amount of derivative contracts under the agencies' regulatory capital rule.

The highlights of the notice of proposed rulemaking (NPR) are described by the FDIC as follows:

- The "standardized approach for measuring counterparty credit risk" (SA-CCR) described in the NPR would: (1) replace the current exposure methodology (CEM) in the capital rule's advanced approaches with SA-CCR as an option to internal models methodology (IMM) for purposes of calculating advanced approaches total risk-weighted assets; (2) require an advanced approaches banking organization to begin using SA-CCR by July 1, 2020, in determining the exposure amount for a derivative contract for purposes of calculating its standardized total risk-weighted assets; and (3) allow a non-advanced approaches banking organization to use either CEM or SA-CCR to determine the exposure amount for its derivative contracts.

- If a banking organization elects to use SA-CCR to determine the exposure amount for its derivative contracts, it also would be required to use SA-CCR to determine the trade exposure amount for cleared derivative contracts and default fund contributions.

- The NPR would simplify the formula used to determine the risk-weighted asset amount for a default fund contribution to be based on the banking organization's pro rata share of the default fund.

- Advanced approaches banking organizations would be required to use a modified version of SA-CCR to determine the exposure amount of derivative contracts for purposes of calculating total leverage exposure under the supplemental leverage ratio.

- The NPR would make technical amendments to the capital rule with respect to cleared transactions.

The comment period for the NPR will end 60 days after publication of the NPR in the *Federal Register*.

The NPR is available here.

UK/BREXIT DEVELOPMENTS

Bank of England and PRA Publish Brexit Package of Consultations and Communications

On October 25, the Bank of England (BoE) and the UK Prudential Regulation Authority (PRA) published a package of Brexit-related communications and consultation papers which propose changes to the relevant onshored binding technical standards (BTS), the rules for financial market infrastructure providers (FMIs) and the PRA Rulebook, which arise from the UK's withdrawal from the European Union.

The package of communications and consultations includes the following:

- Three "Dear CEO" letters, the first to all firms authorized and regulated by the PRA, as well as European Economic Area (EEA) firms undertaking cross-border activities into the United Kingdom from the rest of the EEA via passporting. The other letters are addressed to non-UK central counterparties and non-UK central securities depositories, updating them on the BoE's approach to their preparations for withdrawal from the EU;

- A joint BoE/PRA consultation paper that sets out the general approach to making changes to rules and BTS, including the proposed use of transitional powers. It also contains a draft Supervisory Statement (SS) indicating their expectations of firms and FMIs in relation to EU guidelines and recommendations;

- A PRA consultation paper which sets out the key changes to PRA rules and relevant BTS. The consultation covers changes related to EU legislation where HM Treasury has either published its policy intention, published the related legislation in draft or has laid it before Parliament;

- An FMI consultation paper which sets out the key changes to FMI-related binding technical standards and rules. The consultation also contains a draft SS on the BoE's expectations of FMIs in relation to existing non-binding domestic material; and

- A resolution consultation paper which sets out changes to BTS in relation to resolution. It also proposes how firms should interpret existing BoE Statements of Policy on resolution in light of any deficiencies arising from the UK's withdrawal from the EU.

The proposed changes set out in the consultation papers are intended to ensure that there is a functioning legal framework for UK regulation when the UK leaves the EU. The package of measures does not reflect any policy changes other than those related to EU withdrawal, and builds on previous communications to firms on their preparations around EU withdrawal.

The deadline for comments on all four consultation papers is January 2, 2019.

A press release with links to each of the items in the package is available here.

Cryptoassets Taskforce Publishes Final Report

On October 29, the UK "Cryptoasset Taskforce," consisting of HM Treasury, the UK Financial Conduct Authority (FCA) and the Bank of England, published its final report setting out the United Kingdom's policy and regulatory approach to cryptoassets and distributed ledger technology (DLT) in financial services. The Cryptoassets Taskforce was established in March 2018 as part of the United Kingdom's strategy on the financial technology (FinTech) sector (for further details see the March 23 edition of the *Corporate & Financial Weekly Digest*).

The report provides an overview of cryptoassets and DLT, assesses their associated risks and potential benefits, and sets out next steps regarding UK regulation. It also commits the relevant regulators to taking actions that will, for example, allow innovators in the financial sector to thrive if they comply, and that will maintain the UK's international reputation as a safe and transparent place to do business in financial services. The report suggests the following actions, among others, to be taken by the relevant regulators:

1. By the end of 2018, the FCA is to consult on guidance to clarify which cryptoasset activities are or should be regulated;

2. By the end of 2018, the FCA is also to consult on potentially prohibiting the sale of derivatives based on cryptoassets to retail investors; and

3. HM Treasury is to consult on transposing the Fifth Money Laundering Directive in the New Year and introduce new legislation in 2019, to further broaden the scope of anti-money laundering and counter-terrorism finance regulation.

The Cryptoassets Taskforce will also convene every six months to continue to monitor market developments and regularly review the United Kingdom's regulatory approach to cryptoassets and DLT.

The final report is available here.

Updated Advisory Notice on Money Laundering and Terrorist Financing Controls in Higher Risk Jurisdictions Published by HM Treasury

On October 25, HM Treasury published an updated advisory notice on money laundering and terrorist financing controls in higher risk jurisdictions.

The Money Laundering, Terrorist Financing and Transfer of Funds (Information of the Payer) Regulations 2017 require firms to implement policies and procedures to prevent activities relating to money laundering and terrorist financing.

On October 19, the Financial Action Task Force (FATF) published two statements (found in Annex A and Annex B of the advisory notice) identifying jurisdictions with strategic deficiencies in their anti-money laundering and counter-terrorism financing regimes. In response to FATF's statements, HM Treasury suggests that firms note the following:

1. Consider the Democratic People's Republic of Korea (North Korea) as a high-risk jurisdiction, and apply countermeasures and enhanced due diligence measures in accordance with the associated risks;

2. Consider Iran as high risk and apply enhanced due diligence measures in accordance with the associated risks;

3. Take appropriate actions, such as enhanced due diligence in high-risk situations, to minimize associated risks relating to the Bahamas, Botswana, Ethiopia, Ghana, Pakistan, Serbia, Sri Lanka, Syria, Trinidad and Tobago, Tunisia, and Yemen.

Additionally, at the time of the advisory notice's publication, North Korea, Iran, Syria, Tunisia and Yemen are subject to financial sanctions which require firms to take additional measures.

The advisory notice is available here.

Details of the financial sanctions to be taken by firms in relation to specific, high-risk jurisdictions are available here.

EU DEVELOPMENTS

EU Update on Obligations of Depositaries Under the UCITS Directive

On October 30, the European Union's Delegated Regulation 2018/1619, amending Delegated Regulation (EU) 2016/438 regarding safe-keeping duties of depositaries (Delegated Regulation), was published in the *Official Journal of the European Union*.

The Delegated Regulation supplements the Undertakings for the Collective Investment in Transferable Securities Directive (UCITS Directive). Fund depositaries' duties regarding the safekeeping of clients' assets are set out in the UCITS Directive, but are further detailed in the amended Delegated Regulation. Additionally, the UCITS Directive requires that where a depositary delegates safekeeping functions to third parties, namely custodians, the assets also need to be segregated at the level of the delegate. The manner in which this requirement is fulfilled is now detailed in the amended Delegated Regulation.

The Delegated Regulation becomes effective on November 19 and will apply beginning April 1, 2020.

Delegated Regulation 2018/1619, amending the Delegated Regulation, is available here, and the Delegated Regulation is available here.

ESMA Publishes Statement Clarifying Clearing and Trading Obligations Ahead of December Deadline

On October 31, the European Securities and Markets Authority (ESMA) published a statement clarifying firms' clearing and trading obligations in light of current derogations and phase-in periods ending on December 21, allowing for regulatory forbearance.

ESMA explains that, under the European Market Infrastructure Regulation (EMIR), both the current derogation from the clearing obligation for certain intragroup transactions concluded with a third-country group entity and the phase-in for non-financial counterparties (NFCs) in Category 4 ("NFCs+), expire on December 21, for the interest rate derivative classes denominated in the G4 currencies subject to the clearing obligation.

In relation to the derogation, ESMA drafted amendments to Commission Delegated Regulations on the clearing obligation to extend the derogation expiration to December 21, 2020. Proposals to amend EMIR (EMIR Refit) envision that NFCs+ would only be subject to the clearing obligation in the asset class or asset classes where their level of activity is above the clearing threshold (for more information on the EMIR Refit, see the June 15 edition of the *Corporate & Financial Weekly Digest*).

However, there is a risk that the above measures will not have gone into effect before December 21. This would mean that affected counterparties would need to have clearing arrangements in place and start clearing transactions, before they are once again no longer required to do so after the amendments enter into force.

ESMA also explains that because financial counterparties and NFCs that benefit from the derogation from the EMIR clearing obligation are also exempt from the trading obligation under the Markets in Financial Instruments Regulation, such counterparties would be subject to the trading obligation until the above measures enter into force.

Given such difficulties, ESMA expects competent authorities not to prioritize their supervisory actions towards affected entities and to apply their risk-based supervisory powers in their day-to-day enforcement of applicable legislation in a proportionate way.

The announcement is available here.

EU Update on Obligations of Depositaries Under AIFMD

On October 30, the European Union's Delegated Regulation 2018/1618, amending Delegated Regulation (EU) 231/2013 as regards safekeeping duties of depositaries (Delegated Regulation), was published in the *Official Journal of the European Union* (*OJ*).

The Delegated Regulation supplements the Alternative Investment Fund Managers Directive (AIFMD). Fund depositaries' duties regarding the safekeeping of alternative investment fund clients' assets are set out in the AIFMD, but are now further detailed in the amended Delegated Regulation. Additionally, the AIFMD requires that where a depositary delegates safekeeping functions to third parties, namely custodians, the assets also need to be segregated at the level of the delegate. The manner in which this requirement is fulfilled is now detailed in the amended Delegated Regulation.

The Delegated Regulation goes into effect on November 19 and will apply from April 1, 2020.

Delegated Regulation 2018/1618, amending the Delegated Regulation, is available here, and the Delegated Regulation is available here.

Renewed Restriction on CFDs Published in the OJ

On October 31, the decision by the European Securities and Markets Authority (ESMA) to renew and amend the temporary restriction on the marketing, distribution or sale of contracts for differences (CFDs) to retail clients was published in the *Official Journal of the European Union* (*OJ*).

The restriction has been in effect since August 1 and, in September, ESMA announced that it was renewing the restriction from November 1 for a further three-month period. ESMA is renewing the restriction as it considers that there is still concern regarding whether there is significant investor protection regarding the offer of CFDs to retail clients (for further details of the concerns raised by the UK Financial Conduct Authority, see the January 12 edition of the *Corporate and Financial Weekly Digest*).

ESMA's decision was made under the Markets in Financial Instruments Regulation, which gives ESMA the power to introduce temporary intervention measures on a three-month basis. Before the end of the three-month period, ESMA must review the measures and consider whether they should be extended for a further three months.

ESMA's decision is available here.

For additional coverage on financial and regulatory news, visit *Bridging the Week*, authored by Katten's Gary DeWaal.

For more information, contact:

FINANCIAL SERVICES

Janet M. Angstadt	+1.312.902.5494	janet.angstadt@kattenlaw.com
Henry Bregstein	+1.212.940.6615	henry.bregstein@kattenlaw.com
Kimberly L. Broder	+1.212.940.6342	kimberly.broder@kattenlaw.com
Wendy E. Cohen	+1.212.940.3846	wendy.cohen@kattenlaw.com
Guy C. Dempsey Jr.	+1.212.940.8593	guy.dempsey@kattenlaw.com
Gary DeWaal	+1.212.940.6558	gary.dewaal@kattenlaw.com
Kevin M. Foley	+1.312.902.5372	kevin.foley@kattenlaw.com
Jack P. Governale	+1.212.940.8525	jack.governale@kattenlaw.com
Arthur W. Hahn	+1.312.902.5241	arthur.hahn@kattenlaw.com
Christian B. Hennion	+1.312.902.5521	christian.hennion@kattenlaw.com
Carolyn H. Jackson	+44.20.7776.7625	carolyn.jackson@kattenlaw.co.uk
Fred M. Santo	+1.212.940.8720	fred.santo@kattenlaw.com
Christopher T. Shannon	+1.312.902.5322	chris.shannon@kattenlaw.com
Robert Weiss	+1.212.940.8584	robert.weiss@kattenlaw.com
Lance A. Zinman	+1.312.902.5212	lance.zinman@kattenlaw.com
Krassimira Zourkova	+1.312.902.5334	krassimira.zourkova@kattenlaw.com

UK/EU/BREXIT DEVELOPMENTS

John Ahern	+44.20.7770.5253	john.ahern@kattenlaw.co.uk
Carolyn H. Jackson	+44.20.7776.7625	carolyn.jackson@kattenlaw.co.uk
Neil Robson	+44.20.7776.7666	neil.robson@kattenlaw.co.uk
Nathaniel Lalone	+44.20.7776.7629	nathaniel.lalone@kattenlaw.co.uk

* Click here to access the *Corporate & Financial Weekly Digest* archive.