Volume 10, Issue 4 | July 24, 2019

STRUCTURED THOUGHTS

NEWS FOR THE FINANCIAL SERVICES COMMUNITY

IN THIS ISSUE

THE SEC'S MARGIN REQUIREMENTS FOR SECURITY-BASED SWAP DEALERS

On June 21, 2019, the Securities and Exchange Commission ("SEC") released its final rules (the "Final Rules") stating margin requirements for security-based swap dealers (each, an "SBSD") and major security-based swap participants (each, an "MSBSP")[1] in connection with security-based swaps ("SBS").[2] The SEC's decision to release its margin rules in final form was contrary to the stated preference of a significant portion of the market, which took the view that, as more than six years had passed since the SEC had proposed the rules in 2012, and as other regulatory bodies since that time had either proposed or finalized margin requirements pursuant to their own mandates, the SEC should repropose the rules rather than issue them in final form. In any event, when implemented, the Final Rules, available here, will require SBSDs to collect margin from, and

[1] In view of the likely rarity of MSBSPs, this article generally focuses on SBSDs and not MSBSPs. The primary difference between the Final Rules' treatment of SBSDs and MSBSPs with respect to margin is that MSBSPs are not required to collect initial margin from any counterparty.

[2] Title VII of the Dodd-Frank Act gives the SEC jurisdiction over "security-based swaps" and the Commodity Futures Trading Commission ("CFTC") jurisdiction over "swaps," each as defined in the Dodd-Frank Act and in a joint rulemaking by the CFTC and SEC. While the CFTC has largely finalized and implemented its regulatory regime for swaps, the SEC has generally not yet implemented its regulatory regime for SBS.

provide margin to, many SBS counterparties. We expect that these requirements will have a significant impact on the economics of the SBS market.

The release accompanying the Final Rules provides market participants with what appears to be an ample amount of time to comply with the rules' requirements. The release sets the date for compliance, both with the rules themselves and with the registration requirement for SBSDs, as 18 months after the later of (i) the effective date of final rules establishing recordkeeping and reporting requirements for SBSDs and MSBSPs or (ii) the effective date of final rules addressing the cross-border application of certain security-based swap requirements. The SEC has not finalized either of these rulesets. While the SEC proposed recordkeeping and reporting rules for SBSDs and MSBSPs some time ago, in 2014, it proposed cross-border rules recently, in May 2019. As a result, the compliance date for the Final Rules will be more, and perhaps significantly more, than 18 months from now.

The Final Rules, which apply to SBSDs not subject to prudential banking regulation ("nonbanks") with respect to non-cleared SBS, resemble both the margin rules of the CFTC (the "CFTC Rules"), which apply to nonbank swap dealers with respect to non-cleared swaps, and the margin rules of the prudential banking regulators (the "PR Rules"), which apply to prudentially regulated banks that are swap dealers or SBSDs with respect to both non-cleared swaps and non-cleared SBS. However, there is only a general resemblance between the Final Rules, on the one hand, and the CFTC Rules and the PR Rules (which in many respects are virtually identical to each other), on the other; the Final Rules follow the SEC's pattern of conforming its rules for SBS to the CFTC's rules for swaps, but not conforming them completely. Given the similarities between the SEC's mandate to regulate SBS and the CFTC's mandate to regulate swaps, and the logistical challenges of complying with similar but different rules for similar but different types of transactions, market participants could be forgiven for wishing a tighter congruence between the Final Rules and the CFTC Rules.

Despite the differences between the Final Rules and the CFTC Rules, however, the Final Rules permit SBSDs, under certain circumstances, to comply with the CFTC Rules rather than the Final Rules. Under an "alternative compliance mechanism" provided by the Final Rules, an SBSD that is registered with the CFTC as a swap dealer, if it meets certain conditions, may treat SBS and related collateral in accordance with the CFTC Rules, rather than the Final Rules, to the extent the CFTC Rules do not specifically address SBS and related collateral.

To avail itself of such alternative compliance mechanism, an SBSD must not be a registered broker or dealer. In addition, among other conditions, the SBSD must engage predominantly in swaps business rather than SBS business. The aggregate gross notional amount of the outstanding SBS positions of the SBSD must not exceed the lesser of (i) 10 percent of the combined aggregate gross notional amount of the SBS and swap positions of the SBSD and (ii) a maximum fixed-dollar amount specified in the Final Rules, which amount will be $250 billion until the three-year anniversary of the Final Rules' compliance date, at which time the maximum fixed-dollar amount will drop to $50 billion unless the SEC issues an order stating otherwise.

The Final Rules require an SBSD to calculate daily for its counterparties both (i) the amount of current exposure (corresponding to variation margin) and (ii) the required amount of initial margin (based in part on potential future exposure). Subject to the exceptions noted below, an SBSD must collect collateral from, or deliver collateral to, its SBS counterparties in relation to variation margin, and must collect collateral from its SBS counterparties in relation to initial margin requirements. Unlike the CFTC Rules and the PR Rules, the Final Rules do not require a dealer to post initial margin to any counterparty. An SBSD must deliver or collect required margin by no later than the close of business of the first business day following the day of the related calculation, unless the counterparty is located in another country and more than four time zones away, in which case the deadline is the second business day following the day of the required calculation.

The Final Rules exempt SBSDs from SBS margin requirements in relation to certain types of counterparties. SBSDs need not collect initial or variation margin, or provide variation margin to (i) SBS legacy accounts, which hold no SBS entered into after the Final Rules' compliance date, (ii) the Bank for International Settlements, the European Stability Mechanism and multilateral development banks or (iii) commercial end users, a term defined with reference to the statutory exception from mandatory clearing for counterparties that are not "financial entities."

In addition, SBSDs need not collect initial margin from (i) counterparties that are financial market intermediaries, such as SBSDs, swap dealers, broker-dealers, futures commission merchants and banks, (ii) sovereign entities, if determined to have only a minimal amount of credit risk, or (iii) SBSDs' own affiliates. With respect to these exceptions relating to initial margin, there are significant differences between the Final Rules and both the CFTC Rules and the PR Rules. Unlike the Final Rules, the CFTC Rules and the PR Rules contemplate that dealers may be required to collect initial margin from other dealers and other types of financial market intermediaries. Further, the Final Rules omit the "material swaps exposure" requirement contained in the CFTC Rules and the PR Rules, under which a dealer may collect initial margin from a non-dealer counterparty only if that counterparty and its affiliates together have an average daily aggregate notional amount of greater than $8 billion in outstanding non-cleared swaps, non-cleared SBS and similar transactions.

Similar to the CFTC Rules and the PR Rules, the Final Rules provide for a $50 million threshold amount for initial margin and a minimum transfer amount of $500,000. Under the $50 million threshold, an SBSD need not collect initial margin to the extent that the initial margin amount, when aggregated with other SBS and swap exposures of the SBSD and its affiliates to the counterparty and its affiliates, does not exceed $50 million. The Final Rules permit SBSDs to defer collecting initial margin from a counterparty for two months after the month in which the counterparty for the first time is no longer subject to the $50 million threshold exception.

Collateral used to satisfy margin requirements under the Final Rules must consist of cash, securities, money market instruments, a major foreign currency, the settlement currency of the non-cleared SBS, or gold. The fair market value of collateral is subject to standardized haircuts. With respect to the types of securities eligible to be used as collateral, the Final Rules are significantly less prescriptive than are the CFTC Rules and the PR Rules, which describe in detail which securities are eligible. The Final Rules provide that collateral used to meet a margin requirement must have a ready market, must be readily transferable, and must not consist of securities issued by an entity related to either party to the SBS.

U.K.'S FCA CONSULTS ON SALES BAN OF CRYPTOASSET DERIVATIVES

In July 2019, the U.K.'s Financial Conduct Authority ("FCA") launched a consultation on its proposal to ban the sale, marketing and distribution of derivatives and exchange traded notes ("ETNs") that reference certain types of cryptoassets (also known as "tokens") to all retail consumers by firms in, or from, the U.K.

The proposed ban would apply to those derivative products that are sold, distributed or marketed in or from the U.K. to retail clients. This would therefore include a ban on sales to U.K. retail clients by other EEA firms, including where the U.K. retail clients seek the products in a reverse inquiry transaction. It would also ban U.K. brokers or platforms from marketing and distributing products available in other jurisdictions to U.K. retail clients. However, it would not prevent U.K. retail clients seeking in-scope products from a non-EEA firm in reverse inquiry transactions.

The proposed ban would include all derivative products that reference unregulated cryptoassets that allow for transferability, i.e., those that can be widely exchanged on cryptoasset platforms or other markets. Derivative products, in this context, will cover contracts for differences, futures and options, and will include not only derivatives that use a single price from a cryptoasset trading platform, but also those that use an index or benchmark price for tokens within the contract. In addition, the FCA proposes to include ETNs where a special purpose vehicle purchases underlying assets equal to the value of the amounts invested by consumers and then issues notes whose redemption value reflects the value of the assets purchased by the vehicle.

Derivative products will only be within the scope of the ban if they reference cryptoassets that meet certain conditions. First, the tokens must not constitute "Specified Investments" (as defined in the FCA Handbook) or e-money. The FCA considers that security tokens that constitute Specified Investments do not pose the same risks as exchange tokens or utility tokens. This is because they offer contractual rights or obligations (for example, an entitlement to share in profits) and therefore, there is a basis for their valuation. In addition, in relation to e-money tokens, the FCA notes that the U.K.'s E-Money Regulations would apply, including the capital and safeguarding requirements of those regulations.

Second, the FCA is only focusing on derivative products and ETNs that reference tokens that are capable of being traded on or transferred through any platform or other market, and are not limited to being transferred to the issuer of the token or to a network operator in exchange for goods or services.

Although derivatives and ETNs are within the scope of the proposed ban, funds are not within the scope. Currently, mainstream authorised retail funds such as undertakings for collective investments in transferable securities ("UCITS") schemes and non-UCITS retail schemes cannot invest in unregulated cryptoassets directly, nor may they invest in derivatives and ETNs that reference them, due to restrictions on the types of eligible assets that these funds can invest in. Qualified investor schemes and unauthorised alternative investment funds can potentially invest in derivatives that reference unregulated tokens. However, both of these types of funds are subject to existing U.K. rules that restrict the promotion of non-mainstream pooled investments, such that they can only be sold to retail investors who are certified high net worth or sophisticated retail clients. Therefore, the FCA considers that the combination of existing restrictions on promotions is sufficient to protect the types of retail clients who can access them.

Similarly, the FCA has no plans to impose restrictions on the sales of these products to non-retail clients.

The FCA is realistic about the likelihood of some firms seeking to circumvent the proposed ban, by, for example, "opting up" to professional client status certain retail clients that are inappropriate for such status. Accordingly, the FCA will continue to monitor these types of activities. The FCA also states that it will monitor the risks of firms seeking to interact with U.K. retail clients through entities that are outside the EU.

The FCA's justifications for this intervention include the following:

- The inability of retail consumers to value the related investment product, due to the complexity of the underlying assets and the lack of transparency around their valuation.
- Retail consumers' lack of knowledge and/or understanding of the nature and risks of cryptoassets, such that they cannot make an informed decision to invest.
- The specific product features--in particular, the volatility of the underlying assets which will be even greater if a product is leveraged.
- The disparity between consumers' expected return and the actual risk of loss, which risk can be exacerbated by financial crime, market abuse and operational risks affecting the underlying market. This includes cyber thefts from exchanges and abusive trading practices, as well as potential "hard fork" events, when a token splits in two.
- The lack of transparency of costs and charges, and the potentially significant impact that these may have on returns.

The FCA has requested feedback on the proposals from interested parties by October 3, 2019. Thereafter, the FCA will publish a final policy statement and final handbook rules in early 2020. The full FCA consultation paper can be accessed here.

FINRA TIGHTENS MARGIN REQUIREMENTS FOR ETNs

In July 2019, FINRA issued Regulatory Notice 19-21, in which it established higher strategy-based margin requirements for exchange-traded notes (ETNs) and options. In addition, FINRA clarified in the notice that ETNs and options on ETNs are not eligible for portfolio margining under FINRA Rule 4210(g).

The full regulatory notice may be found at: http://www.finra.org/sites/default/files/Notice_Regulatory_19-21.pdf

In issuing the notice, FINRA noted the relative complexity of many ETNs. FINRA also noted that ETNs differ from ETFs, in that:

- ETNs are subject to issuer credit risk; and
- ETNs may have "knock-out" features or contain an issuer redemption option, each of which can cause the return on an ETN to differ from the return on an investment in an ETF that tracks the same underlying asset.

INCREASE IN STRATEGY-BASED MARGIN REQUIREMENTS

FINRA Rule 4210(c) sets the maintenance margin requirements on all "margin securities," including different types of debt securities. The rule generally requires strategy-based accounts to maintain equity equal to 25% of the current market value of all margin securities that are long in the account, and the greater of 5% of the principal amount or 30% of the current market value of debt securities that are short in the account. As an exception to this general rule, reduced margin requirements for investment grade debt securities, listed non-equity securities and "other margin eligible non-equity securities" are set forth in Rule 4210(e)(2)(C).

ETNs may technically qualify for these reduced margin requirements (because they are listed on a national securities exchange, and their issuers are generally rated investment-grade). However, FINRA indicated that ETNs have different risk profiles than typical debt securities. Typical debt securities expose investors to issuer credit risk and a greater or lesser degree of interest rate risk, while ETN investors are exposed to issuer credit risk and also the risk of the underlying asset. Because of the significance of the underlying asset to the value of an ETN, FINRA believes that the exceptions provided by Rule 4210(e)(2)(C) should not apply to ETN positions in strategy-based accounts.

As a result, under FINRA Rule 4210(f)(8)(A),[3] FINRA is excluding ETNs from the exceptions that are available for ordinary investment grade debt securities, listed non-equity securities and "other margin eligible non-equity securities." In the notice, FINRA established for ETNs:

- an initial and maintenance margin requirement of 25% of the current market value for ETNs that are held long in an account, and 30% of the current market value for ETNs that held short; and
- an initial and maintenance margin requirement on listed options on ETNs of 20% of the underlying current market value of the ETNs, and a minimum margin requirement of 10% of the underlying current market value of the ETNs, in each case for purposes of the listed options and warrants requirements chart that is included in Rule 4210(f)(2)(E)(i).

In addition, similar to the approach taken by FINRA Regulatory Notice 09-53 as to leveraged ETFs,[4] FINRA is increasing the margin requirements (including day trading requirements) for leveraged ETNs and associated uncovered options by a factor commensurate with their leverage.

We would note that the notice does not contain a specific definition of "ETN." Similarly, the notice does not precisely differentiate "ETNs" from other types of listed equity-linked notes.

PORTFOLIO MARGIN TREATMENT

As an alternative to the strategy-based margin requirements specified in FINRA Rule 4210(c)-(f), FINRA Rule 4210(g) permits members to margin certain products according to a portfolio margin methodology that is based on the Options Clearing Corporation's (the "OCC") Theoretical Intermarket Margining System ("TIMS") model. Portfolio margin is a risk-based margin methodology designed to align margin requirements for equity securities with the overall risk of the portfolio. Portfolio margin usually results in lower margin requirements on hedged positions than strategy-based margin rules would impose on these hedged positions.

ETNs and options on ETNs historically have been included in the TIMS file provided by the OCC. As a result, some broker-dealers have provided portfolio margin treatment to ETNs and options on ETNs when these products are held in a customer's portfolio margin accounts. However, ETNs are not on the list of products that are eligible to be included in portfolio margin, as set forth in FINRA Rule 4210(g)(6). Therefore, FINRA determined that broker-dealers may not apply the portfolio margin requirements provided by the TIMS model for positions in ETNs and options on ETNs that are held in portfolio margin accounts. In August 2019, the OCC will be removing all ETNs and related options that are currently in the TIMS file.

HARDSHIP EXTENSION

FINRA has attempted to provide relief in cases where these steps result in undue hardship to a firm or its customers. In such a case, the broker-dealer firm may submit a written request to FINRA for additional time to comply with the notice. Written requests must include an explanation of the specific circumstances leading to the request, and must be received by July 26, 2019.

CONCLUSION

We do not expect the notice to have a significant impact on ETN issuances; these issuances are mainly dependent on addressing the investment strategies of particular types of investors. However, the notice reflects a concern about ETNs and leveraged ETNs and their risks that have gained wider attention in recent years.

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[3] This provision permits FINRA, when it determines that market conditions warrant, prescribe higher margin requirements or other conditions.

[4] This notice may be found at the following link: https://www.finra.org/sites/default/files/NoticeDocument/p119906.pdf

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