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Dodd-Frank 5 Years Later: Where Are We Now? Derivatives Regulation for Asset Managers

Assessing the practical implications of derivatives regulations for investment advisers and investment funds of: position limits and aggregation rules, uncleared swaps margin rules, etc.

Since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) more than five years ago, the US Commodity Futures Trading Commission (CFTC) and other regulators have finalized several rulemakings applicable to investment managers that qualify as commodity pool operators (CPOs) and commodity trading advisors (CTAs). Investment managers — including those of private funds (*i.e.*, funds relying on 3(c)(1) or 3(c)(7) for exemption from registration as an investment company under the Investment Company Act) — that transact in derivatives should already be familiar with the general scheme of the CFTC's registration requirements and exemptions for CPOs and CTAs and aware of their own CPO and/or CTA status. Certain other key derivatives rulemakings are, however, on the horizon, which will likely have further practical implications for investment advisers and the funds that they manage.

The following rulemaking initiatives that have been recently finalized, or are slated to be in the near future, and other derivatives regulatory matters that may affect certain investment managers, include:

- Position Limits and Aggregation Rules. The CFTC's proposed rules on position limits and aggregation would establish specific limits on speculative positions in certain physical commodity futures and option contracts, as well as swaps that are economically equivalent to such contracts. Moreover, the proposed aggregation rules would require market participants to aggregate their positions with certain affiliates and other entities under common ownership or control with such market participant for purposes of the position limits. The position limit and aggregation rules will impact private equity funds, certain hedge funds and other collective investment vehicles. Notably, if a private equity fund owns multiple portfolio companies that in turn trade derivatives, the fund may be required to monitor those positions to assess whether the levels are exceeded — taking the fund and its controlled portfolio companies together — or, in many cases, confirm whether an exemption is available and proper notices have been filed. Hedge funds will no longer be able to benefit from the broad scope risk management exemptions upon which they may currently rely. The CFTC recently indicated that it plans to finalize these rules by early 2016.

- Margin Requirements for Uncleared Swaps. The prudential regulators recently finalized margin rules for uncleared swaps which are discussed in detail in a separate client alert available here. Compliance with the rules will be phased-in beginning in September 2016, although most investment funds will not be required to comply with the rules until March 2017. The final margin rules require investment funds to post variation margin (*i.e.*, funds to secure against current mark-to-market changes in the value of a swap) for their uncleared swap transactions, and will require certain investment funds to post initial margin (*i.e.*, collateral provided at the inception of the transaction to secure against potential adverse changes in the credit risk posed by the counterparty) if the fund has exceeded a certain exposure threshold. For investment managers that are accustomed to negotiating customized collateral packages under their ISDA agreements, the margin rules represent a significant departure from current practice. Funds will need to account for — and have access to liquidity in order to be able to make — daily margin calls in respect of their uncleared swap positions. The CFTC has separately proposed and is slated to finalize in the near future similar margin rules that apply to non-prudentially-regulated entities that are CFTC-registered swap dealers or major swap participants.

Similarly, the European Union (EU) has proposed regulatory technical standards with respect to margin for uncleared swaps (Proposed EU Margin Rules). US funds that transact with EU banks will be subject to EU margin requirements. While the Proposed EU Margin Rules are similar to the US final margin rules in many respects, the rules currently diverge with respect to the treatment of investment funds. Under the Proposed EU Margin Rules many investment funds will not be required to post initial or variation margin, which may create certain regulatory arbitrage opportunities. Most recently the EU has stated that it is revisiting the treatment of certain entities classified as non-financial counterparties (including investment funds), which may eventually close the loop on the divergence between the rules regarding the treatment of funds. The EU has stated that it plans to finalize the Proposed EU Margin Rules soon.

Proposed Position Limits and Aggregation Requirements

The CFTC's proposed position limits rule — one of the more controversial rulemakings under the Dodd-Frank Act — would establish specific limits on speculative positions in 28 physical commodity futures and option contracts, as well as on swaps that are economically equivalent to such contracts. The CFTC's position limits were initially proposed in 2011, but faced litigation and extensive public comment which led the CFTC to re-propose its position limits rule in late 2013 (the Proposed Position Limits Rule).[1] In addition, the CFTC proposed a separate rule to address the circumstances under which market participants would be required to aggregate their positions with other entities under common ownership or control (the Proposed Aggregation Requirements)[2] for purposes of the position limits, and also published a supplement to the Proposed Aggregation Requirements (the Aggregation Supplement) on September 29, 2015.[3]

Key Aspects of the Proposed Position Limits Rule

Contracts Subject to Position Limits

The Proposed Position Limits Rule would apply to 28 physical commodity futures and option contracts (Core Referenced Futures Contracts), as well as to swaps that are economically equivalent to such contracts. The designated Core Referenced Futures Contracts are contracts transacted on a specified futures exchange. For example, in the energy industry, the Core Referenced Futures Contracts likely to be relevant for funds or their portfolio companies are:

- New York Mercantile Exchange (NYMEX) Light Sweet Crude Oil
- NYMEX NY Harbor ULSD
- NYMEX RBOB Gasoline
- NYMEX Henry Hub Natural Gas

For purposes of the Proposed Position Limits Rule, swaps will be considered economically equivalent to a Core Referenced Futures Contract if they are linked or priced at a fixed differential to the price of a particular Core Referenced Futures Contract. The Core Referenced Futures Contracts together with their economically equivalent swaps are referred to in the Proposed Position Limits Rule collectively as "Referenced Contracts."

Persons Subject to Position Limits

The Proposed Position Limits Rule would generally apply to any market participant transacting in Referenced Contracts, regardless of whether the participant is registered with the CFTC or is a financial entity. The Proposed Position Limits Rule does not describe the circumstances under which the rule would apply to non-US persons. However, the CFTC stated in its "cross-border guidance" that position limits rules "apply regardless of the counterparty's status (US person or not)." The Proposed Position Limits Rule may therefore have a broad extraterritorial scope.

Position Limit Levels

The Proposed Position Limits Rule sets the maximum number of Referenced Contracts that a market participant may hold or control, either net long or net short, unless an exemption applies. Separate positions limits would apply for: (i) spot months (*i.e.*, the trading period immediately preceding the delivery period for physical-delivery futures contracts as well as for any cash-settled contracts that are linked to such physical-delivery contracts); and (ii) non-spot months (*i.e.,* limits applied to positions in all contract months combined or in any single contract month). The levels of the initial spot month limits are set forth in an appendix to the current proposal and would be adjusted after two years. In contrast to spot month limits, which are set based on estimated deliverable supply, non-spot month limits would be based on total open interest for all Referenced Contracts in a commodity.

Exemptions from the Position Limits

The proposed position limits are subject to numerous exemptions, most notably for contracts that qualify as "bona fide hedging transactions." For any position to qualify as a bona fide hedging position, two general requirements must be met: (i) the purpose of the position must be to offset price risks incidental to commercial cash operations; and (ii) the position must be established and liquidated in an orderly manner in accordance with sound commercial practices. (Additional requirements will apply to certain transactions.)

As a practical matter, an investment fund trading in Referenced Contracts would appear unlikely to benefit from the bona fide hedging exemption, because a fund typically would not be trading in Referenced Contracts to hedge actual commercial operations. Furthermore, the Proposed Position Limits Rule would, in effect, revoke previously-granted risk management exemptions for hedge funds, pension funds, and other financial institutions trading futures contracts in excess of existing speculative limits to manage risks associated with financial investment portfolios. On the other hand, to the extent a fund's portfolio companies trade Referenced Contracts to hedge actual commercial operations, the bona fide hedging exemption will provide a measure of relief if the fund's positions are aggregated with the positions of its portfolio company under the Proposed Aggregation Requirements.

Proposed Aggregation Requirements

Under the Proposed Aggregation Requirements, a market participant is generally required to aggregate all Referenced Contract positions for which that participant controls the trading decisions with all such positions for which that participant has a 10% or greater ownership interest in an account or position, as well as the positions of two or more persons acting pursuant to an express or implied agreement or understanding. Given the low threshold on aggregation, the Proposed Aggregation Requirements may substantially impact collective investment vehicles such as private equity funds that invest in portfolio companies with Referenced Contract positions. For example, if a private equity fund owns multiple portfolio companies that trade derivatives, the fund would need to monitor those positions, assess whether the Referenced Contract positions exceed *in the aggregate* the set position limits and determine whether an exemption — *e.g.*, the proposed bona fide hedging exemption — is available and whether a notice claiming the exemption must be filed with the CFTC.

The CFTC has suggested that market participants manage aggregation issues by allocating the position limits among multiple entities and requiring each to trade within their share of the limit. In many cases, however — especially if a fund does not have control of trading decisions or if portfolio companies may need to engage in significant hedging activity that individually or collectively require claiming the bona fide hedging exemption — such allocations may not be a workable solution. Accordingly, for fund structures and entities with large numbers of subsidiaries that may trade Referenced Contracts, the position limits rules may require fund managers to (i) seek to procure that all or most Referenced Contracts are entered into for bona fide hedging purposes (and that the proper notices are filed); or (ii) seek an exemption for position limits aggregation, in particular, under the "owned entity exemption," which as a practical matter imposes certain conditions and may require certain filings with the CFTC.

Under the owned-entity exemption, as revised by the recent Aggregation Supplement, a person would be permitted to disaggregate the positions of an entity in which the person has greater than a 10% ownership or equity interest, provided that the persons, among other things, have no knowledge of the trading decisions of one another, trade under independent trading systems, maintain and enforce written procedures to preclude each other from having knowledge of trades of the other, share no employees that control trading decisions, and have systems that do not permit sharing of risk management strategies. To rely on the exemption, the relevant owner would be required to file a notice with the CFTC and provide certain information about itself and the owned entity.

Margin Requirements for Uncleared Swaps

The Dodd-Frank Act mandates the margining of uncleared swaps and requires federal regulators to implement rules that cause swap dealers (such as banks) and certain other entities to collect and post initial and variation margin with certain counterparties.

On October 22, 2015, federal banking regulators voted to adopt rules implementing margin requirements for uncleared swaps (the PR Margin Rules).[4] The PR Margin Rules apply to (among other entities) prudentially-regulated entities, such as certain banks and insurance companies that are swap dealers or security-based swap dealers (PR Covered Swap Entities).

The CFTC has also proposed margin rules for uncleared swaps (CFTC Proposed Margin Rules) that would apply to non-prudentially-regulated entities that are CFTC-registered swap dealers,[5] such as foreign banks without a presence in the US (CFTC Covered Swap Entities and, together with PR Covered Swap Entities, Covered Swap Entities). Further, the CFTC will likely adopt final rules in the near future that are substantially similar to the PR Margin Rules (except, perhaps, in relation to cross-border application of the rules) and, like the PR Margin Rules, generally align with the international standards issued in 2013 by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (BCBS-IOSCO) (the International Standards). As a practical matter, the application of the PR Margin Rules or the CFTC's margin rules will turn on the status of a fund's counterparty — if a fund's counterparty is subject to regulation by one of the federal banking authorities, the PR Margin Rules apply; if the fund's counterparty is not subject to the jurisdiction of a federal banking authority but is otherwise registered as a swap dealer or a major swap participant, then the CFTC's rules will apply.

The US Securities Exchange Commission has also proposed, but not otherwise finalized margin rules for uncleared security-based swaps. The SEC margin rules would apply when the fund enters into an uncleared security-based swap with a registered security-based swap dealer or major security-based swap participant but is not otherwise regulated by the prudential regulators.[6]

Key Aspects of the PR Margin Rules for Investment Funds

Under the PR Margin Rules, Covered Swap Entities entering into uncleared swaps with other Covered Swap Entities or with "financial end users" must collect and post variation margin on a daily basis. In addition, Covered Swap Entities facing other Covered Swap Entities or financial end-users with a material swaps exposure will be required to collect and post initial margin.

The term "financial end-user" is defined broadly and would include, among other entities: private funds, registered investment companies, investment advisers, business development companies, certain private real estate investment entities, securitization vehicles, commodity pools, CPOs and CTAs. Accordingly, investment managers and the funds that they manage will likely be required to post variation margin to their dealer counterparties in connection with uncleared swaps. They will also be required to post initial margin to the extent that they have a "material swaps exposure."

Meaning of Material Swaps Exposure

Under the PR Margin Rules, a financial end-user is considered to have a "material swaps exposure" if such entity and its affiliates, in the aggregate, have an average daily notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July, and August of the previous calendar year that exceeds US$8 billion (calculated only for business days).

The PR Margin Rules abandoned the control-based approach taken under their initial proposal and have instead opted for a bright-line test whereby for purposes of the material swaps exposure calculation for a particular entity, an affiliate of an entity is one whose financial statements are consolidated on such entity's financial statements or if both the entity's and the affiliate's financial statements are consolidated on a third-party's financial statements.

Acceptable Collateral and Segregation of Collateral

The forms of collateral that may be posted as initial margin under the PR Margin Rules generally include cash, certain government and corporate debt securities, certain listed equities, and gold. Non-cash collateral is subject to haircuts.

With respect to variation margin, a PR Covered Swap Entity is only permitted to exchange cash collateral with other Covered Swap Entities, but is permitted to exchange cash or any non-cash collateral that is eligible to satisfy the above initial margin requirements with financial end-users. As a result, investment funds will be permitted to use cash and other forms of eligible collateral to satisfy their variation margin posting requirements.

Variation margin is not required to be segregated or held by an unaffiliated custodian. Covered Swap Entities must, however, hold initial margin which it collects in a segregated account with an unaffiliated custodian, and any collateral which the Covered Swap Entity posted would also be required to be segregated with an unaffiliated custodian.

Impact on Foreign Exchange Forwards and Foreign Exchange Swaps

Physically-settled foreign exchange forwards or foreign exchange swaps are exempt from the margin requirements under the PR Margin Rules. However, as noted above, foreign exchange forwards and foreign exchange swaps are considered in determining whether a financial end-user exceeds the threshold for material swaps exposure. Funds that only hedge foreign currency exposure through foreign exchange swaps and foreign exchange forwards (other than non-deliverable forwards) will not be affected by the PR Margin Rules.

Cross-Border Issues

Globally, regulators have been working together to impose comparable margin requirements in respect of uncleared swaps in their respective jurisdictions. In each case, the International Standards serve as a guide and a regulatory framework on which to base local jurisdiction rules. To date, the EU and Japan have each proposed uncleared swap margin requirements.[7] Many other jurisdictions are expected to follow suit in light of the G-20 commitments.[8]

Investment managers that operate internationally will need to understand the interplay among the margin rules at a global level, which regimes such managers may be subject to and what, if any, differential treatment may exist between a hedging strategy that faces, for instance, an EU or a UK bank, on the one hand, and a US bank on the other. While both US and non-US regulators seek to establish comparable rules, largely following the International Standards in an effort to reduce duplication and the possibilities of regulatory arbitrage and competitive disadvantages/advantage, harmonizing margin regulation across the globe has proven to be a very difficult task.

In fact, the PR Margin Rules, the CFTC Proposed Margin Rules, and the current margin proposals in the EU each have material differences. For instance, under the PR Margin Rules, an exemption from the margin requirements will apply to swaps between PR Covered Swap Entities and foreign counterparties, provided that no US entity guarantees either party's obligation under such swaps. As a practical matter, then, certain offshore funds possibly would not be required to post margin when trading with certain non-US banks, as the EU margin proposal, as currently written, would not require all investment funds to post initial or variation margin. As noted above, however, the EU has recently stated that it is revisiting the treatment of certain entities classified as non-financial counterparties (including investment funds), which may eventually close this potential gap in the rules.[9] Further, in the EU, physically-settled foreign exchange swaps and forwards are subject to the margin requirements, while in the US such instruments would not require posting of margin. Moreover, until rules are finalized in the EU and other foreign jurisdictions and the US regulators have determined whether compliance with such rules would satisfy US margin rules, we will not have clarity on which jurisdiction's rules apply in cross-border circumstances. Further, the finalized PR Margin Rules' cross-border rules differ from the CFTC's proposal with respect to the cross-border reach of the CFTC Margin Rules. The market will need to wait for the finalized CFTC margin rules in order to understand the US reach regarding the extraterritorial application of the margin rules and whether the US regulators (CFTC and prudential regulators) are aligned in their approach.

Compliance Phase-In

Consistent with the International Standards, the phased-in compliance schedule proposed by the Prudential Regulators in September 2014 has been extended under the PR Margin Rules. The compliance dates for the initial and variation margin requirements under the PR Margin Rules will be based on the average daily notional amount of uncleared swaps, uncleared security-based swaps, FX forwards and FX swaps (computed for business days only) for each counterparty (aggregated with its respective affiliates). Entities whose average daily notional amount in such instruments exceed US$3 trillion would be required to begin posting initial margin and variation margin beginning September 1, 2016. Entities with an average daily notional amount less than US$3 trillion would not be required to post variation margin until March 1, 2017, with initial margin requirements, if applicable, further phased in through 2020.

Looking Ahead

In addition to monitoring compliance with existing CFTC regulatory requirements, investment managers should consider the impact of additional CFTC (and SEC) rules with which they could be required to comply in the near future. With respect to the PR Margin rules (and the CFTC's rules that may be finalized later this year), investment managers should consider the scope of their derivatives activity and the circumstances under which they may be required to post margin in connection with their uncleared swaps activity, and whether they have any security-based swap activity that would be subject to regulation by the SEC. With respect to position limits, the CFTC has indicated that it will likely finalize its rules by early 2016 at which time investment managers should assess the impact of such rules to their funds.

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CFTC Proposes Cross-Border Application of Margin Requirements for Uncleared Swaps

Endnotes

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