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By Peter M. Hong and Nicole Simon

NEW AND DEVELOPING CFTC REGULATION

Adoption of Final Rule Regarding Margin for Uncleared Swaps

On January 6, 2016, the Commodity Futures Trading Commission (CFTC) published its final rules that impose initial and variation margin requirements for swap dealers (SDs) and major swap participants (MSPs) that are not subject to oversight by the Prudential Regulators (the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency) (Covered Swap Entities or CSEs).[1] The rules establish initial and variation margin requirements for (i) trades between CSEs and SDs or MSPs and (ii) trades between CSEs and financial end users (*e.g.*, private funds, commodity pools, commodity pool operators (CPOs), commodity trading advisors (CTAs), introducing brokers, and futures commission merchants (FCMs)). With respect to initial margin, the rules require daily two-way margin (posting and collecting) for all trades between CSEs and SD/MSPs. The rules also require daily two-way initial margin for all trades between CSEs and financial end users that have over $8 billion in gross notional exposure in uncleared swaps, FX forwards and FX swaps. With respect to variation margin, the rules require daily two-way margin for all trades between CSEs and SD/MSPs, as well as all trades between CSEs and financial end users.

While CSEs undoubtedly will spearhead efforts to ensure their own (and, indirectly, their counterparties') compliance with the rules, buy side counterparties and investment managers entering into uncleared swaps on their behalf should carefully review the rules now in order to determine how they will be impacted and what actions they should be taking in order to be ready for the new requirements that the rule will place upon them.

For calculation of initial margin, the rules provide CSEs the flexibility to choose between a standardized grid-based calculation or an internal risk-based model approved by the CFTC or National Futures Association (NFA). Under certain circumstances, it may be appropriate to employ both a risk-based model and a standardized grid approach to calculating initial margin. The rules do not require a CSE to collect or to post initial margin collateral to the extent that the aggregate un-margined exposure either to or from its counterparty remains below $50 million. For calculation of variation margin, the rules require the use of methods and inputs that rely on recent trades or third-party valuations.

The rules permit CSEs to calculate initial margin or variation margin on an aggregate net basis across uncleared swap transactions that are executed under an eligible master netting agreement (EMNA). The EMNA may identify one or more separate

netting portfolios that independently meet the requirement for close-out netting and to which, under the terms of the EMNA, the collection and posting of margin applies on an aggregate net basis separate from and exclusive of any other uncleared swaps covered by the agreement. The parties may document two separate netting sets, one for uncleared swaps that are subject to the rule and one for swaps that are not subject to the margin requirements. A netting portfolio that contains only uncleared swaps entered into before the applicable compliance date is not subject to the requirements of the rule. The rules do not prohibit the parties from including one or more pre-compliance date swaps in the netting portfolio of uncleared swaps subject to the margin rule, but they will thereby become subject to the rules' margin requirement, as part of the netting portfolio. Similarly, any netting portfolio that contains any uncleared swap entered into after the applicable compliance date will subject the entire netting portfolio to the requirements of the rules.

Initial margin must be held at an independent custodian and there can be no re-hypothecation of required initial margin. Permissible initial margin includes cash, sovereign debt, government-sponsored debt, investment-grade debt including corporate bonds, equities, gold and shares of certain funds with appropriate haircuts. In contrast, variation margin must be paid in cash for all trades between CSEs and SD/MSPs. However, variation margin can be of the same nature as initial margin for all trades between CSEs and financial end users.

Initial margin requirements will be phased in starting September 1, 2016, and ending September 1, 2020, with entities engaged in higher volumes of swap activity having earlier compliance dates. Variation margin requirements are effective as of September 1, 2016, for entities with the highest volume of swap activity and March 1, 2017 for the rest. To provide additional information for CSEs seeking NFA approval of a risk-based initial margin model by September 1, 2016, NFA has scheduled a webinar for Tuesday, May 3, 2016.

The CFTC also adopted and invited comments on an interim final rule that exempts certain uncleared swaps with certain counterparties from the new margin requirements. This interim final rule implements Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015, which exempts from the margin rules for uncleared swaps certain swaps for which a counterparty qualifies for an exemption or exception from clearing under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Comments on the interim final rule were due February 5, 2016.

Proposed Regulation AT

In late 2015, the CFTC proposed a series of risk controls, transparency measures and other safeguards to enhance the regulatory regime for algorithmic trading systems (ATSs) on U.S. designated contract markets (DCMs) (collectively, Regulation AT).[2] As proposed, Regulation AT would set forth risk controls and other requirements for (a) market participants using ATSs, who are defined as "AT Persons" in the proposal, (b) clearing member FCMs, with respect to their AT Person customers, and (c) DCMs executing AT Person orders. The term "AT Persons" includes any person registered or required to be registered as a FCM, SD, MSP, CPO, CTAs, or introducing broker that engage in algorithmic trading on a DCM.

The proposal would also require the registration of certain proprietary traders that, while responsible for significant trading volumes in key futures products, are not currently registered with the CFTC. This requirement would be applicable specifically to proprietary traders engaged in algorithmic trading through direct electronic access to a DCM. The proposal would require such entities to register with the CFTC, if not already registered in another capacity.

The comment period for the CFTC proposed Regulation of Automated Trading closed on March 16, 2016.

Adoption of Amendments to Rule 1.35

Just before the start of the quarter, on December 24, 2015, the CFTC published final rule amendments to CFTC Rule 1.35(a) relating to recordkeeping obligations for certain market participants.[3] Rule 1.35(a) requires FCMs, retail foreign exchange dealers, IBs and members of a swap execution facility (SEF) or DCM — including SEF or DCM members that are not registered or required to register with the CFTC (Unregistered Members) — to keep full, complete and systematic records of all transactions relating to commodity interest transactions and related cash or forward transactions. The amendments exclude Unregistered Members from the rule's requirements to keep written communications that lead to the execution of a commodity interest transaction and related cash or forward transactions ("written pre-trade communications") or text messages,[4] and from the rule's specific form and manner requirements. The amendments also exclude CTAs from the requirement to record and keep records of oral

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communications that lead to the execution of a commodity interest transaction ("oral pre-trade communications"). More generally, the amendments clarify that all records, except for oral and written pre-trade communications, must be kept in a form and manner that allows for identification of a particular transaction. The amendments to the rule were adopted largely as proposed, with two key differences: (1) the CFTC clarified that Rule 1.35(a) records may be maintained in a manner that it deems appropriate, as long as this manner permits prompt, accurate and reliable location, access and retrieval of any particular record, data or information; and (2) the final rule excludes Unregistered Members from the requirement to maintain written pre-trade communications.

The amendments to Rule 1.35(a) became effective December 24, 2015.

CFTC STAFF LETTERS AND GUIDANCE

The CFTC staff issued a number of exemption and no-action letters during the first quarter of 2016. Set forth below are those particularly worthy of note to CPOs and CTAs.

Relief from CPO and CTA Registration Requirement for the Board of Trustees of a Pension Plan Group Trust (Letter 16-07)

On January 13, 2016, the staff of the CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO) issued no-action relief from CPO and CTA registration for the board of trustees (the Board) of a pension plan group trust (the Trust).[5] The participating plans comprising the Trust were pension plans that were either excluded from the "pool" definition under Rule 4.5(a)(4) or a "qualifying entity" under Rule 4.5(b)(4), for which their operator would be able to claim an exclusion from the definition of a CPO. The issue that gave rise to the need for relief was that there is no express provision in Rule 4.5 that would provide relief for an operator of a pension plan group trust (*i.e.*, a trust comprised of multiple plans), which in turn renders the Rule 4.6 exclusion from the definition of a CTA unavailable. Consistent with prior practice and based on the facts set forth in the letter,[6] the staff agreed that it would not recommend enforcement action pursuant to Section 4m(1) of the Commodity Exchange Act (CEA) for failure to register with the CFTC as a CPO or CTA against any individual member of the Board with respect to their operation of the Trust, provided that they operate and advise the Trust in a manner that meets the conditions in Rules 4.5(c)(2) and 4.6.

Rule 3.10(c) Relief for Swaps Not Subject to a CFTC Clearing Requirement (Letter 16-08)

CFTC Rule 3.10(c)(3)(i) provides an exemption from registration as a CPO, CTA or IB for persons engaging in certain commodity interest transactions in the United States where the person is located outside the United States and the person acts only on behalf of persons located outside the United States. The rule also requires that certain commodity interest transactions be submitted for clearing through a registered FCM. However, not all swaps are required by the CFTC to be cleared and some swaps are not yet accepted for clearing by any derivatives clearing organization. In a letter issued on February 12, 2016, the DSIO staff confirmed that Rule 3.10(c)(3)(i) was not intended to impose an independent clearing requirement on commodity interest transactions that the CEA and CFTC rules do not otherwise require to be cleared, and agreed not to recommend an enforcement action against a person located outside the United States, its territories or possessions engaged in the activity of an IB, CTA or CPO in connection with swaps not subject to a CFTC clearing requirement only on behalf of persons located outside the United States, its territories or possessions, for failure to register in such capacity.[7] The relief is set to expire on the later of the effective date or compliance date of any final rule amending Rule 3.10(c)(3)(i) to clarify this issue.

Additional Guidance Regarding Form CPO-PQR (Letter 16-22)

On February 25, 2016, the DSIO staff responded to a joint letter from the Investment Company Institute (ICI), Investment Adviser Association (IAI) and Managed Funds Association (MFA) requesting that the DSIO consider revising or, in the alternative, providing relief from certain positions articulated by the DSIO in a recent publication providing answers to frequently asked questions concerning CFTC Form CPO-PQR (the FAQs).[8] The three topics covered in the letter were (1) the treatment of parallel managed accounts for reporting purposes (relating to FAQ 7[9]), (2) reporting monthly rates of return (relating to FAQs 29, 30 and 31[10]) and (3) spot currency positions (relating to FAQ 42).

With respect to the treatment of parallel managed accounts for reporting purposes, the DSIO staff provided exemptive relief from aggregating and reporting Parallel Managed Accounts (as defined on Form CPO-PQR) to the pool with the largest AUM to which the Parallel Managed Accounts

relate until the reporting period ending December 31, 2016, for all CPOs.

With respect to reporting monthly rates of return, the DSIO staff reaffirmed that CPOs are required to report monthly rates of return on the form, but explained that with respect to certain illiquid and other hard-to-value assets, the rates of return reported on the form for the intra-quarter months is satisfied if the CPO reports estimates of the monthly rates of return, so long as such rates of return are based on reasonable methodologies (*i.e.*, such methodologies would result in estimated rates of return that are reasonably consistent with rates of return that would be calculated if all assets and positions are revalued at current market values). The staff also clarified that they do not expect CPOs to recalculate rates of return and amend prior submissions in light of the FAQs, or populate future submissions with respect to the previous reporting periods.

Finally, with respect to spot currency positions, the staff confirmed that the purpose of FAQ 42 had been to clarify where spot currency positions should be reported on Form CPO-PQR and not to define the term. Accordingly, the FAQ should not be interpreted as limiting otherwise applicable definitions of spot currency transactions available to CPOs or other market participants.

NFA DEVELOPMENTS

Cybersecurity Guidance

March 1, 2016, marked the effective date of the Interpretive Notice Regarding Information Systems Security Programs — Cybersecurity (the Notice) issued by the NFA on October 23, 2015.[11] The Notice applies to all NFA members, including CPOs, CTAs, introducing brokers (IBs), FCMs, retail foreign exchange dealers, SDs and MSPs. The guidelines set forth in the Notice are similar to those addressed in guidance issued by other regulators, including the April 2015 Guidance Update issued by the Securities and Exchange Commission's Division of Investment Management,[12] but NFA's guidance is more detailed and uses different terms, requiring firms to consider whether their current cybersecurity programs adequately address the guidelines.

More specifically, the Notice requires each NFA member to adopt and enforce a written information systems security program (ISSP) in accordance with general guidelines set forth by NFA. Specifically, the Notice states that written ISSPs must be approved within firms by an executive-level official and should contain (i) a security and risk analysis; (ii) a description of the safeguards against identified system threats and vulnerabilities; (iii) the process used to evaluate the nature of a detected security event, understand its potential impact, and take appropriate measures to contain and mitigate the breach; and (iv) a description of the member's ongoing education and training related to information systems security for all appropriate personnel. Firms are required to monitor and regularly review (*i.e.*, at least every 12 months) the effectiveness of their ISSPs and make adjustments as appropriate. In the Notice, NFA provided possible resources that members might consider using in developing their ISSPs. While members are not required to utilize any of the resources listed, the NFA does expect them to use a formal process to develop an ISSP appropriately tailored to their business.

A firm that is part of a larger holding company structure that shares information systems security personnel, resources, systems and infrastructure can meet the foregoing requirements through its participation in a consolidated entity ISSP. Additionally, a firm's specific policies and procedures may be documented in a single document or in documents maintained throughout the firm's various departmental areas, so long as the ISSP can be made available upon appropriate requests by the NFA

NFA Launched a New Online Registration System Homepage Called the "Dashboard"

On February 26, 2016, NFA officially launched its new "Dashboard," which replaced the former home page for NFA's Online Registration System (ORS) in what NFA has described as the first phase of a multiyear rebuild of ORS. The Dashboard is a single screen intended to summarize all outstanding NFA filings so users can quickly see what is required and address open items. Authorized users can access the Dashboard by visiting NFA's home page, clicking "Login" in the ORS box, and entering their current ORS username and password. On February 25, 2016, NFA hosted a webinar during which senior staff explained the functionality of the Dashboard, provided screenshots and answered questions from NFA members. For anyone who might have missed it, an archived recording and transcript are available on NFA's website at https://www.nfa.futures.org/NFA-compliance/NFA-education-training/webinars.HTML.

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and the CFTC. To that end, firms whose ISSP is integrated into various documents might consider creating a "road map" document to make it easier to respond to any such requests from the NFA or the CFTC.

Lastly, the NFA recognized that some members might face a significant challenge implementing ISSPs by the March 1 effective date, and acknowledged that any programs that are adopted will be refined over time. The NFA stated that it expects to devote appropriate resources, such as providing additional guidance, to assist members as they develop and implement their ISSPs.

LITIGATION NEWS

Opinion Issued in MetLife, Inc. v. Financial Stability Oversight Council

In an opinion issued on March 30, 2016, and subsequently unsealed on April 8, 2016, the United States District Court for the District of Columbia ruled that Financial Stability Oversight Council's (FSOC) designation of MetLife Inc. (MetLife) as a "systemically important financial institution" or "SIFI" was "arbitrary and capricious," and rescinded FSOC's final determination.[13]

This case is not an action by or against the CFTC or NFA. However, the Chair of the CFTC sits as a voting member of FSOC, along with members and representatives from the other major U.S. capital markets and prudential regulators, and FSOC is sometimes referred to as a "super regulator" with responsibility for monitoring systemic risk across the financial markets. For this reason, many participants in the financial markets, including CPOs, CTAs, and other asset managers, watch FSOC developments closely for their potential impact on future U.S. financial regulation.

Section 113 of the Dodd-Frank Act empowers FSOC to designate a nonbank financial company as a SIFI if the company's "material financial distress" or activities could pose a threat to the financial stability of the United States. Designation as a SIFI in turn subjects the company to the supervision of the Board of Governors of the Federal Reserve System under enhanced prudential standards. The SIFI designation process is governed by rules and interpretive guidance adopted by FSOC.

On December 18, 2014, FSOC had voted 9-1 to designate MetLife as a SIFI, pursuant to Section 113 of the Dodd-Frank Act and based on four primary conclusions. According to FSOC's final determination: (1) exposed counterparties could suffer significant losses if MetLife

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experienced material financial distress; (2) the same financial distress might prompt MetLife to liquidate assets quickly and thereby disrupt capital markets; (3) existing regulatory scrutiny would not be able to stop either threat from being realized; and (4) MetLife's complexity would hamper its resolution and thus "prolong uncertainty, requiring complex coordination among numerous regulators, receivers, or courts that would have to disentangle a vast web of intercompany agreements."

On January 13, 2015, MetLife filed a complaint in the United States District Court for the District of Columbia pursuant to Section 113(h) of the Dodd-Frank Act, challenging FSOC's designation of MetLife as a nonbank SIFI. In its complaint, MetLife argued — among other things — that FSOC had failed to comply with the statutory requirements and its own rules governing designation.

The Court rescinded FSOC's final determination on two grounds, after agreeing "as an initial matter" that the company was eligible for such a designation. First, the Court found that FSOC had "made critical departures from two of the standards it adopted in its own guidance,[14] never explaining such departures or even recognizing them as such," which "render[ed] FSOC's determination process fatally flawed." Second, the Court found that FSOC had "purposefully omitted any consideration of the cost of designation to MetLife" in its cost-benefit analysis. For these reasons, the Court found that FSOC's determination had been arbitrary and capricious.

The most significant takeaway from the ruling is the Court's interpretation of the Dodd-Frank Act's command

to consider all "appropriate" risk-related factors as requiring a full cost-benefit analysis. The Court went so far as to say, "In the end, cost must be balanced against benefit because '[n]o regulation is "appropriate" if it does significantly more harm than good,'" citing the Supreme Court's relatively recent decision in Michigan v. Environmental Protection Agency, 135 S. Ct. 2699 (2015).

On April 20, 2016, FSOC appealed the ruling to the United States Court of Appeals for the D.C. Circuit.

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[1] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016), available at http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320a.pdf.

[2] Regulation of Automated Trading, 80 Fed. Reg. 78,824 (Dec. 17, 2015), available at http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-30533a.pdf.

[3] Records of Commodity Interest and Related Cash or Forward Transactions, 80 Fed. Reg. 80,247 (Dec. 24, 2015) (Adopting Release), available at https://www.gpo.gov/fdsys/pkg/FR-2015-12-24/pdf/2015-32416.pdf. See also Records of Commodity Interest and Related Cash or Forward Transactions, 79 Fed. Reg. 68,140 (Nov. 14, 2014) (Proposing Release), available at http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2014-26983a.pdf.

[4] "Text messages" were defined as any written communication sent from one telephone number to one or more telephone numbers by short message service (SMS) or multimedia messaging service (MMS), and not those written communications exchanged by proprietary messaging services.

[5] CFTC Staff Letter 16-07 (Jan. 13, 2016), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/16-07.pdf.

[6] In the letter the staff noted that they have previously granted CPO and CTA registration relief in similar situations involving pension plan group trusts, citing CFTC Staff Letters 12-72 (Dec. 21, 2012), 01-08 (Aug. 11, 2008), 97-94 (Nov. 21, 1997), 94-52 (Jun. 2, 1994), 93-91 (Sept. 7, 1993) and 86-8 (Apr. 4, 1986).

[7] CFTC Staff Letter 16-08 (Feb. 12, 2016), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/16-08.pdf.

[8] CFTC Staff Letter 16-22 (Feb. 25, 2016), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/16-22.pdf. See also CFTC Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions Regarding Commission Form CPO-PQR (Nov. 5, 2015), available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/faq_cpocta110515.pdf.

[9] In FAQ 7, the DSIO had stated that for reporting purposes, Parallel Managed Accounts (as defined on Form CPO-PQR) should be aggregated Parallel Managed Accounts relate, in accordance with Instruction 3 on Form CPO-PQR.

[10] In each of FAQs 29, 30 and 31, the DSIO staff had stated that Form CPO-PQR requires a CPO to report monthly rates of return for a pool.

[11] NFA Compliance Rules 2-9, 2-36 and 2-49: Information Systems Security Programs, NFA Interpretive Notice 9,070 (Aug. 20, 2015), available at http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9070&Section=9; NFA Adopts Interpretive Notice Regarding Information Systems Security Programs — Cybersecurity, NFA Notice to Members I-15-23 (Oct. 23, 2015), available at https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4649.

[12] IM Guidance Update No. 2015-02: Cybersecurity Guidance (Apr. 2015), available at https://www.sec.gov/investment/im-guidance-2015-02.pdf.

[13] MetLife, Inc. v. Financial Stability Oversight Council, No. 15–0045, 2016 WL 1391569 (D.D.C. Mar. 30, 2016).

[14] 12 C.F.R. § 1310 App. A. ("FSOC Guidance for Nonbank Financial Company Determinations").

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