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Understanding the SEC's evolving derivatives regulatory framework

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Presenters

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Agenda

- Introduction
- Regulating Security-Based Swaps
- Moving Beyond Release 10666
- After Dodd-Frank

Introduction

- Over the course of the next twelve months, several new derivatives rules promulgated by the SEC will come into effect. These regulatory changes will impact a wide array of market participants and may require additional legal and compliance spend and impact the cost of implementing certain derivatives programs.

- As of August 19, 2022, registered investment funds ("**RICs**") and business development companies ("**BDCs**") will need to comply with the SEC's new derivatives use rule, which alters decades-old regulatory precedent. [1]

- As of November 1, 2021, market participants transacting in security-based swaps ("**SBS**") with registered security-based swap dealers ("**SBSDs**") will need to navigate new reporting, business conduct and margining requirements. [2]

- While targeting different risks, these two programs add an additional layer of complexity to an already crowded regulatory derivatives space following the 2008 financial crisis and the passage of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**").

- This presentation will focus on the aspects of these developments that are most relevant to the buy-side (i.e., funds, corporates, etc.).

Introduction (continued)

- Generally speaking, a derivative is a financial product that derives its value from the value of a referenced asset, liability or measurement. Derivatives may be traded between two parties ("**OTC**") or exchange-traded.

- By means of example, in a physically-settled foreign exchange forward, one party agrees to sell a given amount of one currency to another party for another specified amount of another currency at a specified date in the future. Such a transaction can be used to mitigate the risk of fluctuating exchange rates.

- Another example is an interest rate swap. In a typical fixed-for-floating interest rate swap, at regular intervals (e.g., quarterly), one party pays the other the product of a fixed interest rate and an agreed notional amount in exchange for the product of a floating interest rate and the same agreed notional amount. The result is an exchange of cash flows.

- Yet another example is an equity call option. In this trade, the buyer pays a premium to the seller at inception of the transaction. If the referenced equity (e.g., common stock of a public issuer) exceeds an agreed strike price, the option buyer may (but need not) demand that the seller deliver the agreed amount of referenced equity for a price equal to the strike price, regardless of the then-current market value of the referenced equity.

Introduction (continued)

- Derivatives played a key role in the 2008 financial crisis. Specifically, credit default swaps stood at the center of several now-infamous highly engineered financial products such as synthetic collateralized debt obligations.

- The perceived risks of derivatives catalyzed a global regulatory reassessment. In Europe, this took the form of regimes such as EMIR, UK EMIR and FMIA. In the United States, this took the form of Dodd-Frank and the various rules and regulations promulgated thereunder by the CFTC, SEC and other prudential regulators (such as the OCC and the FDIC).

- These regulations have subtle differences, but they fundamentally all focus on (1) market transparency via reporting regulations, (2) mandatory central clearing and exchange-trading of certain derivatives products, and (3) risk-mitigation standards (such as mandatory margin).

- The tumult also prompted the SEC to reevaluate its historical approach to the regulation of derivatives use by RICs and BDCs.

Part I: Regulating security-based swaps

Regulating security-based swaps: Background

- Dodd-Frank tasks the SEC with implementing regulations governing SBS. [9]
- Understanding what trades are regulated, and by which agency, isn't necessarily straightforward.

SBS

- Single-name credit default swaps
- Single-name total return swaps (e.g., equities, loans, etc.)
- Single-name security forwards (other than physically-settled)
- Swaps on narrow-based security indices

Options on single securities and single security indices are neither SBS nor swaps

Physically-settled forwards are generally neither SBS nor swaps

Regulating security-based swaps: What are SBS

- Like many of the CFTC's Dodd-Frank derivatives rules, the SEC's Dodd-Frank derivatives rules are primarily focused on the "sell-side".

- Specifically, the onus of regulatory compliance generally falls on registered entities – security-based swap dealers ("**SBSD**") and major security-based swap participants ("**MSBSP**").

- The "SBSD" category includes all persons who (1) hold themselves out as a dealer in SBS; (2) make a market in SBS; (3) regularly enter into SBS with counterparties as an ordinary course of business for their own account; or (4) engage in any activity causing them to be commonly known in the trade as a dealer or market maker in SBS. [10]

    - *However*…a person who enters into SBS "for such person's own account, either individually or in a fiduciary capacity, but not as part of a regular business" is <u>not</u> an SBSD.

    - *Additionally*…persons who meet the *de minimis* conditions are exempted from registration; thresholds are *significantly lower* than CFTC thresholds! The "dealer-trader" distinction is important in determining SBSD status.

- Like the "MSP" category, the "MSBSP" category requires very large trading volumes.

Regulating security-based swaps: Implementation[11]

Apr 6 2020
Effective date for cross-border security-based swap rule amendments.

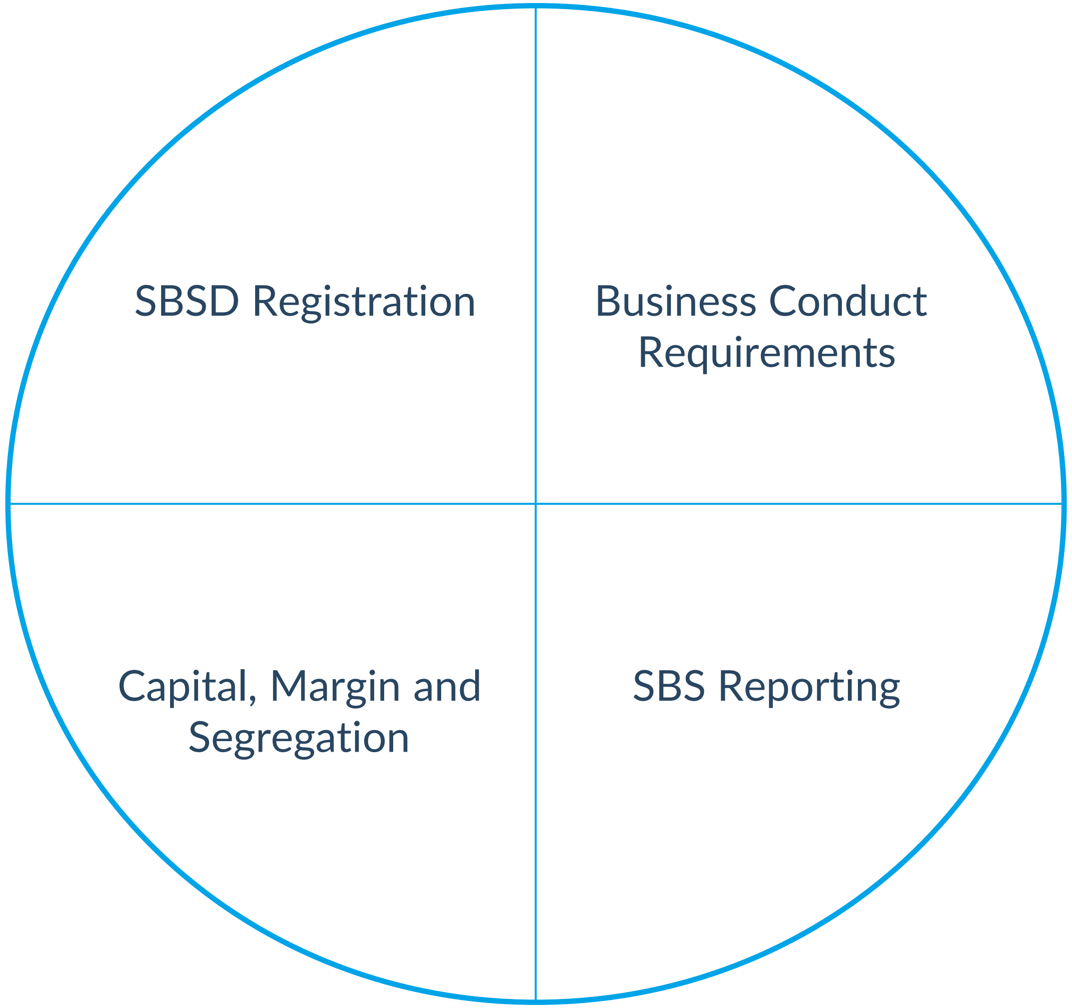
Aug 6 2021
Counting date for thresholds in SBS entity definitions (referred to as the "counting date").

Oct 6 2021
Compliance date for certain rules applicable to SBS entities (referred to as the "registration compliance date").

Nov 1 2021
Registration applications due from security-based swap dealers that incur a registration obligation on the counting date.

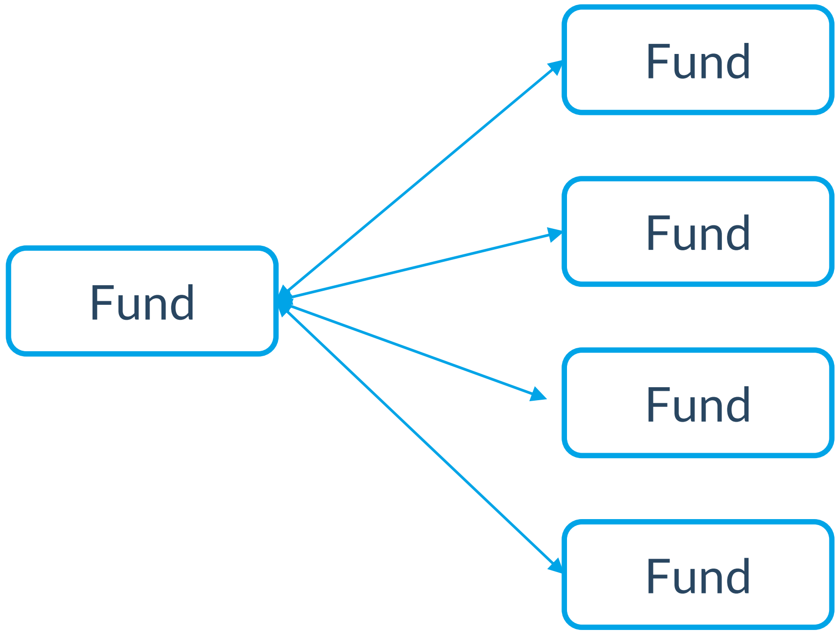
Dec 1 2021
Registration applications due from major security-based swap participants that incur a registration obligation as a result of security-based swap activities in their quarter ending September 30, 2021.

Regulating security-based swaps: Core components [12]



- In many respects, these categories map onto existing CFTC regulation, with the exception of mandatory central clearing.
- The most impactful category for end-users/ “buy-sides” is likely to be the margin and capital rules.
- Generally speaking, reporting, and business conduct requirements are dealer-side burdens.
- Margin, on the other hand, runs to the core economics of trading.

Regulating security-based swaps: Market-making



- It is expected that most SBSD registrants will follow the first model to the left (i.e., dealer makes markets in SBS).

- That said, given the low thresholds, it's *possible* that certain buy-side institutions who engage in similar dealer-like activity could find themselves in an SBSD registration gray area.

- While the *de minimis* threshold for credit default swaps is between $3-$8 billion in gross notional (depending on a phase-in schedule), the threshold for other equity derivatives is between $150-$400 million in gross notional.

Regulating security-based swaps: Business conduct and risk mitigation[13]

- Like the CFTC, the SEC requires registered SBSD/MSBSP to comply with several business conduct rules; these include, among other things, requirements to provide certain valuation information to clients, obtain comfort regarding the degree of client sophistication in derivatives trading, appoint a chief compliance officer, and establish policies and procedures aimed at compliance.

- Similarly, the SEC requires registered SBSD/MSBSP to engage in certain risk mitigation activities with respect to derivatives portfolios with clients.

- All these requirements necessitate that the SBSD/MSBSP obtain information and undertakings from clients. Clients typically provide this with respect to swaps (CFTC-regulated) via ISDA Protocols (colloquially known as "Dodd-Frank protocols").

- Clients may use the ISDA 2021 SBS Top-Up Protocol to "apply" this information to SBSD/MSBSP counterparties.

Regulating security-based swaps: Margin

Dealer Regulator	Product	Applicable Margin Rule
Only CFTC (SD)	Swap	CFTC
Only CFTC (SD)	SBS	N/A
Only SEC (SBSD)	Swap	N/A
Only SEC (SBSD)	SBS	SEC
CFTC/SEC (SB/SBSD)	Swap	CFTC
CFTC/SEC (SB/SBSD)	SBS	SEC
Prudential	Swap	Prudential
Prudential	SBS	Prudential

The SEC's new margin and capital rules fill a gap in the regulatory landscape for non-prudentially-regulated swap dealers. These have not, to date, been subject to mandatory uncleared derivatives margin rules with respect to their SBS dealing activity.

Regulating security-based swaps: Margin [14]

- The SEC's new margin rules require mandatory bilateral variation margin for all SBS, subject to limited exceptions.

- The SEC's new rules require one-way mandatory initial margin, subject to a $50 million threshold. This is a key point of departure from the CFTC/prudential margin rules, which only impose mandatory initial margin on market participants who have over $8 billion gross notional in uncleared derivatives. Accordingly, implementation for mandatory initial margin has been delayed for market participants with less than $50 billion gross notional in uncleared derivatives in recognition of similar delays under the CFTC/prudential margin rules.

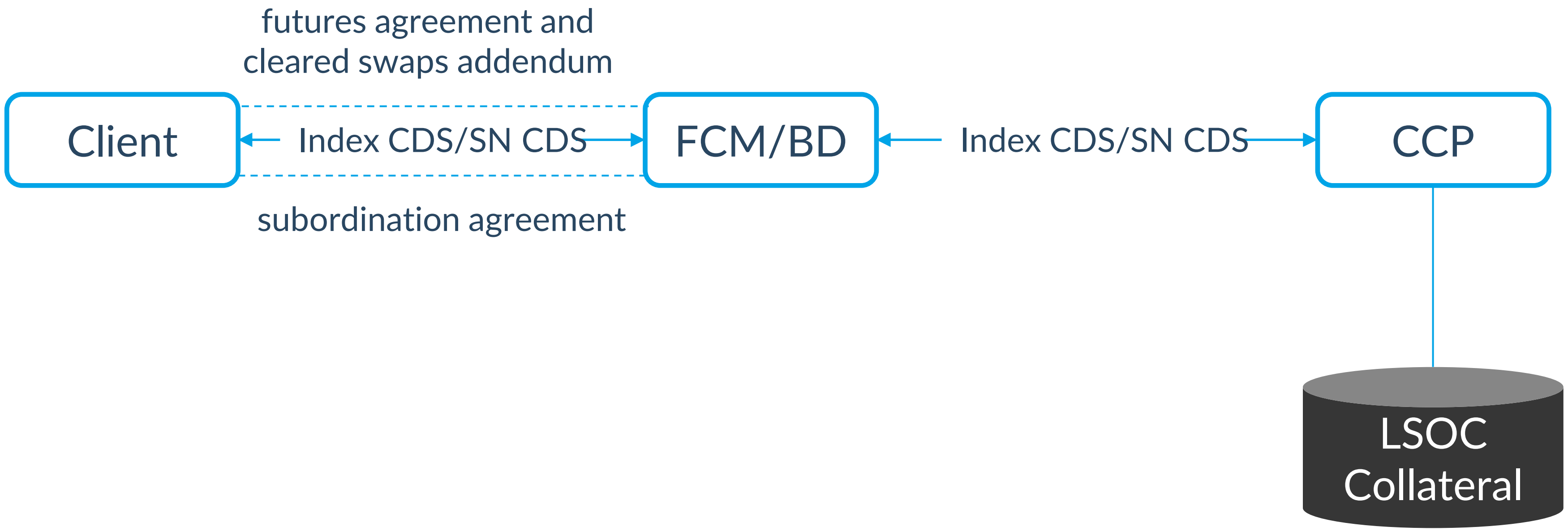
- Minimum transfer amounts of up to $500,000 are permitted.

- The SEC's new margin rules also require margin segregation in certain contexts; the architecture is drawn from the commission's well-known Rule 15c3-3.

- *Commercial end users* are not subject to the margin requirements. These are generally non-financial entities that use derivatives to hedge or mitigate commercial risk.

Regulating security-based swaps: cleared CDS

- Since 2012, the SEC has permitted the portfolio margining of index CDS (swaps) and single-name CDS (security-based swaps) pursuant to LSOC subject to certain conditions.
- The SEC plans to update its requirements for such portfolio margining in the coming year.
- Recall that SBS are not yet subject to mandatory clearing, so single-name CDS clearing is optional.



Part II: Moving beyond 10666

Moving beyond Release 10666: Background

- The Investment Company Act of 1940 (the "**1940 Act**") limits the ability of RICs and BDCs to issue "senior securities". A "senior security" is "any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness." [3]

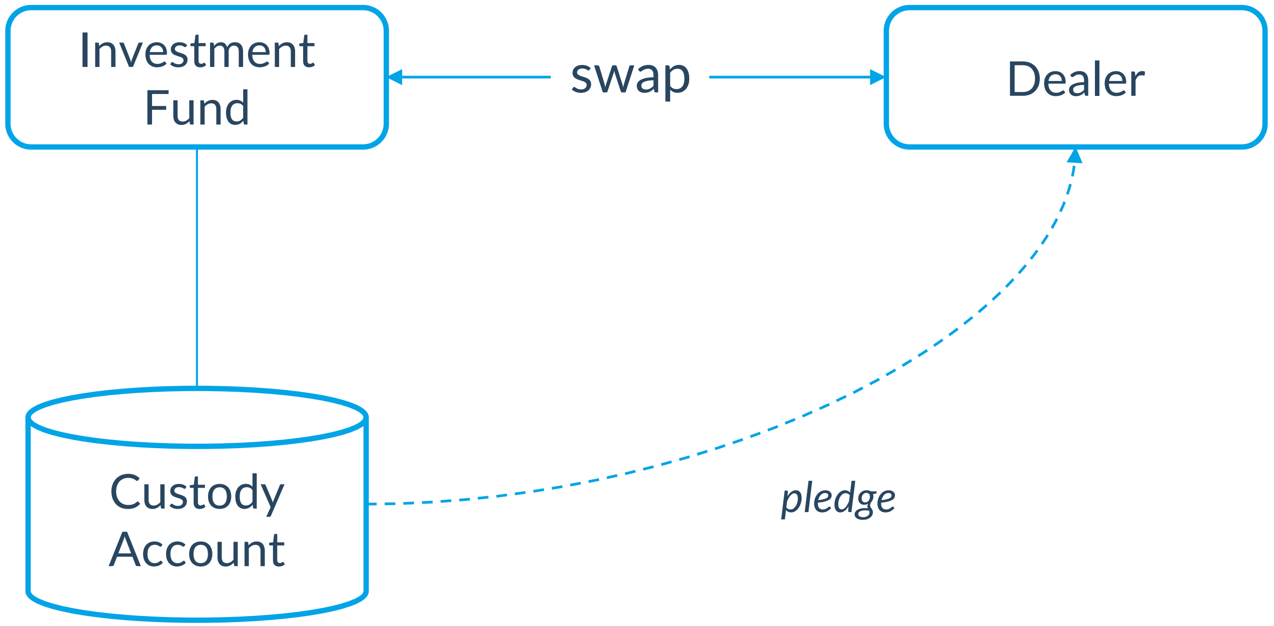
- RICs and BDCs are subject to leverage limits under Section 18 of the 1940 Act, which are designed to ensure fund investments are not "unduly speculative" and that funds operate with "adequate assets and reserves".

  - E.g., under Section 18, open-end RICs can only borrow from banks and borrowings are effectively limited to 50% of net assets; closed-end funds can issue senior debt up to 50% of net asset but can borrow from non-bank sources

- Prior to the adoption of Rule 18f-4, "Release 10666," adopted in 1979, served as the foundational guidance on the use of derivatives and certain other leveraging transactions, such as repurchase agreements, by RICs and BDCs.[4]

- In Release 10666, as modified by subsequent no-action letters and interpreted through disclosure review comments, the SEC permitted RICs and BDCs to engage in derivatives transactions notwithstanding the senior security limits of Section 18, so long as they "covered" their obligations under such instruments with liquid assets or offsetting positions.

Moving beyond Release 10666: Asset segregation



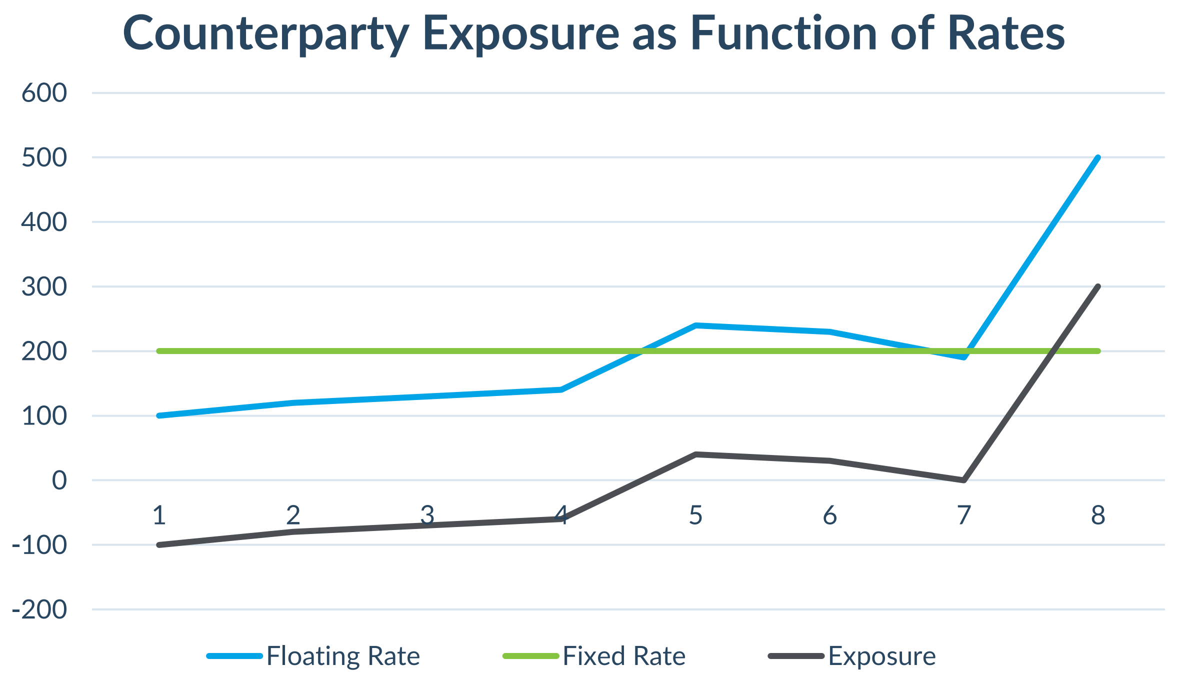
- In a typical arrangement, a RIC or BDC will put liquid assets as collateral in a segregated custody subaccount which is pledged to its derivatives counterparty pursuant to an account control agreement. No dealer rehypothecation is permitted.
- This enables the fund to comply with each of (i) the 1940 Act's Section 17 custody requirements, (ii) any applicable OTC margin regulations and (iii) the Release 10666 cover requirements.
- Different derivatives effectively enabled different approaches to cover (e.g., physically-settled versus cash-settled derivatives), and not all funds interpreted the requirements of Release 10666 in the same way.

Moving beyond Release 10666: Asset segregation (cont.)

- By means of example, imagine a fund has entered into a fixed-to-floating swap where it receives 2% on a notional of 100 each payment period and owes a floating rate each payment period.

- When the floating rate is 1%, the fund is a net receiver under the swap (2% – 1%)*100 = 100. A similar result occurs when the floating rate is 2%. No payment is required by the fund (2% – 2%)*100 = 0. Based on day 7's value, for example, the fund may not need to set aside anything to cover.

- Note, however, that overnight, the value of the trade can change significantly. It is possible that the fund could find itself in a situation where it doesn't have enough liquid assets set aside to make payments on day 8 (2% - 5%)*100 = -300. This could result in a claim by the derivatives counterparty of an amount that would constitute leverage under Section 18 of the Act.

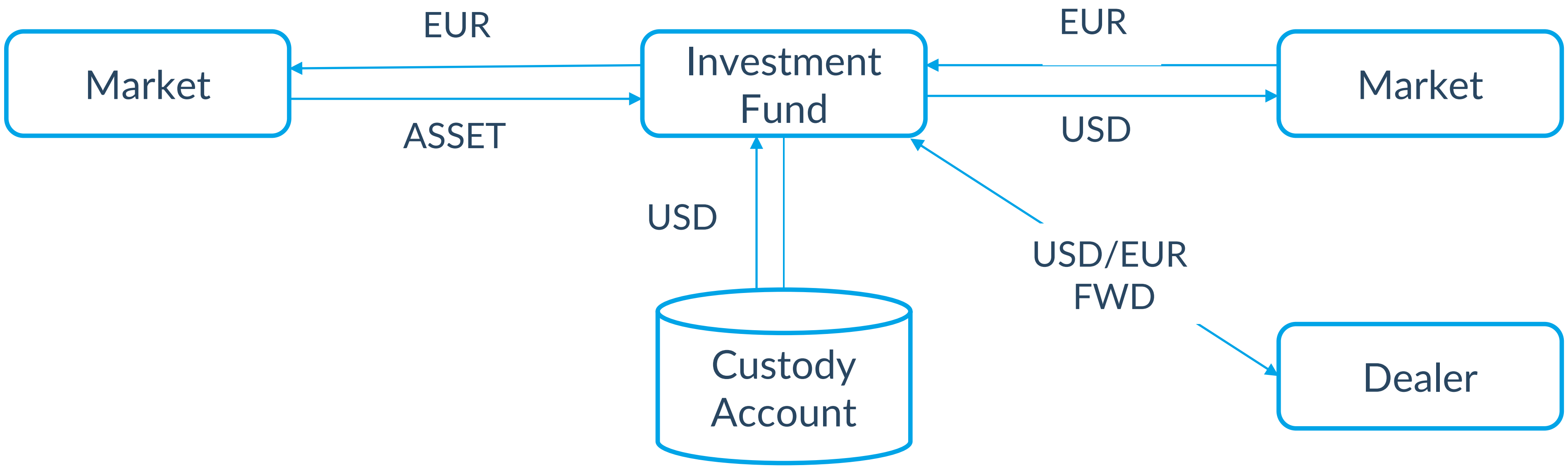


Note that the notional amount doesn't equate to quantum of risk. For example, a hypothetical fund's $1 billion interest rate swap doesn't equate to $1 billion in risk. For example, if the fund is paying a fixed rate of 2% against a floating rate, the fund's max yearly risk is $20,000,000.

Moving beyond Release 10666: Offsetting transactions

- As an alternative to asset segregation, SEC no-action letters interpreting Release 10666 permitted funds to hold offsetting positions to “cover” their derivatives exposure.

- For example, funds widely use physically-settled foreign exchange forwards. Regardless of the fluctuating relative values of the relevant currencies, the fund would be fully covered if it maintain the currency to be delivered.



Moving beyond Release 10666: The new regime

"…current asset segregation practices…may not assure the availability of adequate assets to meet funds' derivatives obligations, on account of both the amount and types of assets that funds may segregate. When a fund's derivatives payment obligations are substantial relative to the fund's liquid assets, the fund may be forced to sell portfolio securities to meet its derivatives payment obligations…" [5]

10666	Financial Crisis	Concept Release	Proposed Rule	Re-Proposed Rule	Effective Date
1979	2008-2009	2011	2015	2019	2022

Moving beyond Release 10666: The new regime (cont.)

- The new derivatives framework in Rule 18f-4 jettisons the Release 10666 “coverage” approach in favor of a VaR-based regime. VaR, or “value at risk”, is a measure of expected loss in an investment (or portfolio thereof) over a given time horizon based on a specified probability. [6]

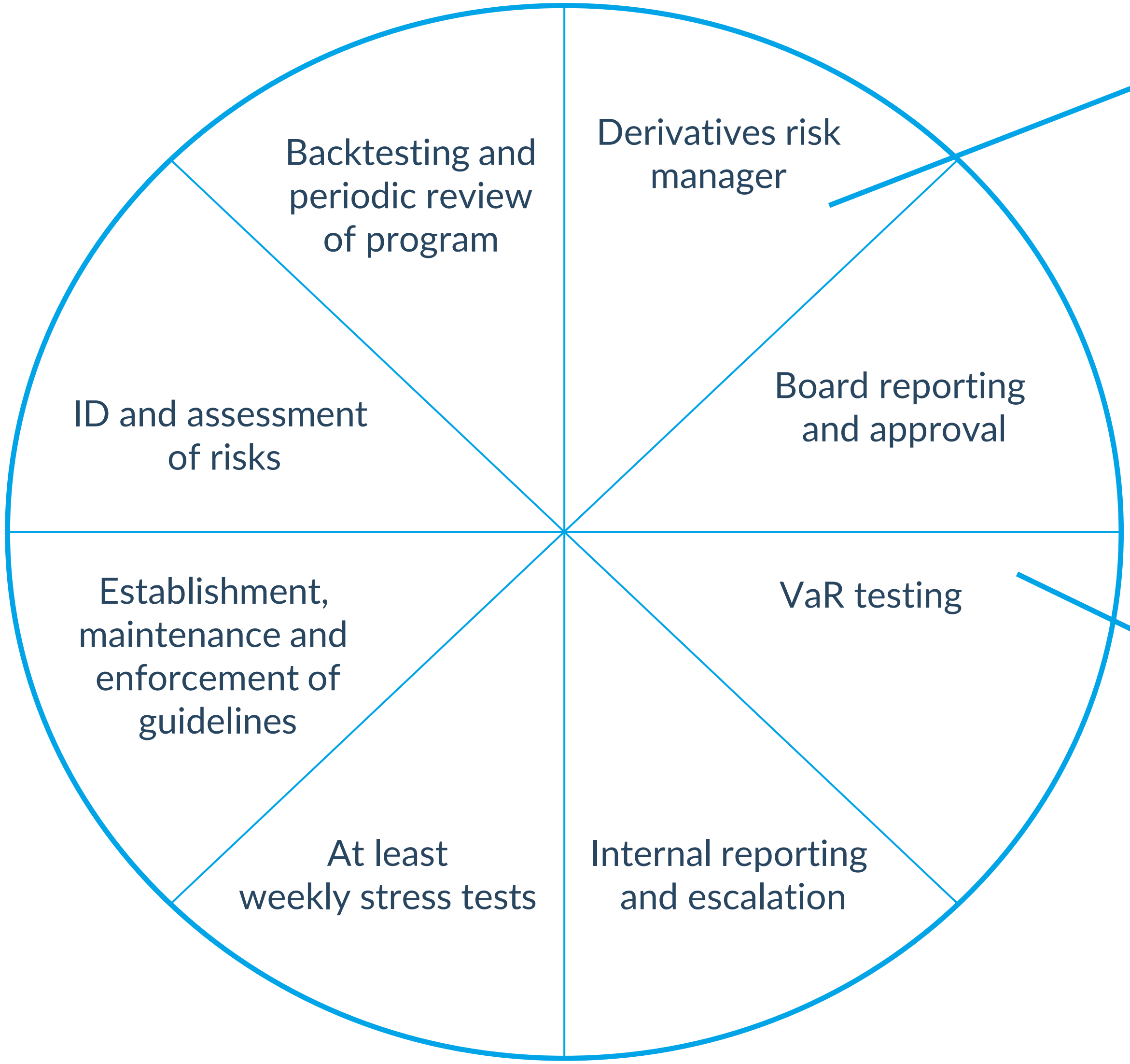
- It also requires the implementation of a fulsome derivatives risk management program. Unlike the approach set forth in Release 10666, which pulled derivatives *out* of the senior security definition, Rule 18f-4 makes clear that derivatives *are* senior securities but are exempted out from the relevant limitations if certain conditions are met.

- Unlike the original proposal, Rule 18f-4 does not impose a notional limit on derivatives use. This is responsive to market comment emphasizing that notional sizing is not a useful measure of risk.

- Subject to limited exceptions, under Rule 18f-4, RICs and BDCs that transact in derivatives must adopt a derivatives risk management program meeting specified requirements.

- “Limited derivatives users” are not required to implement a derivatives risk management program.

Moving beyond Release 10666: Core components



Officer(s) of investment adviser responsible for administering the program and policies and procedures; cannot be a PM and must have relevant experience

Relative VaR test unless the derivatives risk manager reasonably determines that a designated reference portfolio wouldn’t provide an appropriate reference portfolio for purposes of the relative VaR test, in which case use absolute VaR test

Moving beyond Release 10666: Limited derivatives users [8]

(A) Adopts and implements written policies and procedures designed to manage the fund's derivatives risk

(B) Derivatives exposure doesn't exceed 10% of net assets, *excluding* currency or interest rate derivatives that hedge currency or interest rate risks associated with one or more specific equity or fixed-income investments held by the fund, or the fund's borrowings

- "Derivatives exposure" is based on gross notional amounts; generally speaking, this doesn't give any reductive effect to offsetting transactions.
- Note that "derivatives exposure" includes short positions and, in certain circumstances, repo.
- Funds are permitted to convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta-adjust notional amount of options contracts.

Part III: After Dodd-Frank

After Dodd-Frank

Q: Have we solved the problem we set out to solve?

Q&A

References

1. 85 FR 245 (Monday, December 21, 2020) at 83162, *available at* https://www.govinfo.gov/content/pkg/FR-2020-12-21/pdf/2020-24781.pdf.
2. https://www.sec.gov/page/key-dates-registration-security-based-swap-dealers-and-major-security-based-swap-participants.
3. 15 USC § 80a-18.
4. 44 FR 83 (Friday, April 27, 1979) at 25128, *available at* https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf.
5. 85 FR 245 (Monday, December 21, 2020) at 83169.
6. 17 CFR § 270.18f-4.
7. *Id.*
8. *Id.*
9. Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, - July 21, 2010, Subtitle B – Regulation of Security-Based Swap Markets, Sec. 761 et. seq.
10. 17 CFR § 240.3a71-1.
11. https://www.sec.gov/page/key-dates-registration-security-based-swap-dealers-and-major-security-based-swap-participants.
12. 17 CFR § 240.
13. *Id.*
14. 17 CFR § 240.

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