UNDETERRED CFTC UNANIMOUSLY APPROVES THREE PROPOSED RULES, TWO FINAL RULES AT FIRST VIRTUAL OPEN MEETING

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U.S. Asset Management and Investment Funds Alert

The Commodity Futures Trading Commission (CFTC or Commission) recently held its first virtual open meeting and unanimously approved three proposed rules and two final rules. Chairman Heath Tarbert emphasized that, for the rest of 2020, the CFTC plans to finish its current agenda. By this summer, the CFTC will propose rules that have been completed by Staff and are ready to be reviewed by the Commissioners. Until the end of the year, the CFTC also plans to finalize outstanding proposals that have arisen prior to and during Chairman Tarbert's tenure. By doing so, the CFTC plans to respond to market volatility caused by the COVID-19 pandemic while also continuing the important policy initiatives of the CFTC. In addition, the CFTC has not ruled out the possibility of additional regulatory relief to respond to continued market volatility, the COVID-19 pandemic and related government actions.

During the Open Meeting, the CFTC approved:

1. Proposed Amendments to the Part 190 Bankruptcy Regulations (Proposed Part 190 Amendments):[1] If adopted, the Proposed Part 190 Amendments would enhance the protection of market participants' property and encourage open positions to be transferred from the bankrupt commodity broker to a solvent broker. The proposed rule would be the first update to the CFTC's rules on commodity broker bankruptcies since their enactment in 1983. *Comments regarding the proposed rule must be received on or before 13 July 2020.*
2. Proposed Amendments to Compliance Requirements for Commodity Pool Operators (CPOs) on Form CPO-PQR:[2] The proposal would eliminate the pool-specific reporting requirements, require Legal Entity Identifiers (LEIs), and allow the filing of National Futures Association (NFA) Form PQR as a substitute.
3. Proposed Amendments to the Part 50 Clearing Requirements for Central Banks, Sovereigns, International Financial Institutions, Bank Holding Companies, and Community Development Financial Institutions:[3] The proposed revisions would exempt swaps entered into with certain central banks, sovereign entities, international financial institutions, bank holding companies, savings and loan holding companies, and community development financial institutions from the Clearing Requirement. *Comments regarding the proposed rule must be received on or before 13 July 2020.*
4. The Final Rule amending the Part 23 Margin Requirements for the European Stability Mechanism (ESM):[4] The CFTC approved a final rule so that no enforcement actions will be taken against a registered swap dealer that does not follow the uncleared margin rules with respect to swaps entered into with the ESM.

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5. The Final Rule amending the Part 160 Consumer Financial Information Privacy Regulations:[5] The CFTC unanimously approved a final rule that adopts the Commission's proposal to restore detailed requirements for policies and procedures to safeguard customer records and information in Commission Regulation Part 160 that were inadvertently deleted in a 2011 amendment.

PROPOSED RULE: AMENDMENTS TO PART 190 BANKRUPTCY REGULATIONS

For the first time in 37 years, the CFTC is proposing the Proposed Part 190 Amendments to comprehensively update and modernize the CFTC's bankruptcy regime.[6] Notably, the Proposed Part 190 Amendments enhance the protection of market participants' property and encourage open positions to be transferred from the bankrupt commodity broker to a solvent broker. If adopted, the Proposed Part 190 Amendments will directly govern the bankruptcy proceedings for commodity brokers, such as futures commission merchants (FCMs) and derivatives clearing organizations (DCOs), in addition to impacting customers of commodity brokers. Comments on all aspects of the Proposed Part 190 Amendments are due by 13 July 2020.

The Proposed Part 190 Amendments have four primary components:

6. Enhances customer protections;
7. Modernizes the CFTC's bankruptcy regime;
8. Adds additional transparency to Part 190 of the CFTC's regulations; and
9. Addresses changes to the infrastructure of modern financial markets.

Highlights and Key Considerations of the Proposed Part 190 Amendments:

- The Proposed Part 190 Amendments would empower the bankruptcy trustee to port open positions to another commodity broker, which should improve market certainty and liquidity during an insolvency proceeding.
- Learning from prior FCM bankruptcies and acknowledging the evolution of financial products and systems, the Proposed Part 190 Amendments increase the bankruptcy trustee's discretion and ability to act in an expedited manner.
- For the first time, *the CFTC has proposed formal bankruptcy rules for the insolvency of a DCO.*

Improvements to Customer Protections

Most importantly for market participants, including clients of asset manager and investment advisers, the Proposed Part 190 Amendments would reaffirm the special treatment of customer accounts during the insolvency proceedings of commodity brokers.[7] In particular, the Proposed Part 190 Amendments would provide for customers' positions to be promptly transferred to another commodity broker. Learning from the MF Global bankruptcy,[8] this power will allow a bankruptcy trustee to quickly move open positions to another commodity broker and potentially avoid a prolonged dispute over the open positions in bankruptcy court. By allowing the trustee to port positions to another commodity broker, the forced liquidation of customer positions should be reduced and market participants should take comfort that they may not be forced to close open positions at inopportune times or prices. Additionally, even if a market participant is not a direct customer of the bankrupt

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commodity broker, if forced liquidations are limited, all market participants should benefit from market stability, which may also enhance liquidity during potential periods of market stress.

Furthermore, the Proposed Part 190 Amendments would enhance market participants' ability to recover should its commodity broker enter a bankruptcy proceeding. The Proposed Part 190 Amendments would require shortfalls in property segregated for customers to be allocated from a commodity broker's general assets and would require claims of third-party customers to come before proprietary and affiliate claims. Market participants should welcome this clarification, as it ensures third-party customers are entitled to a pro rata distribution based on their respective claims.[9]

Modernizing the CFTC's Bankruptcy Regime and Enhancing Clarity and Transparency

While many of the proposed changes in the Proposed Part 190 Amendments are technical in nature, several changes would modernize the CFTC's bankruptcy regime in material ways. As an initial matter, the Proposed Part 190 Amendments contain core concepts that are designed to help DCOs, FCMs, their customers, bankruptcy trustees, and the public at large understand the CFTC's bankruptcy regime. Furthermore, the Proposed Part 190 Amendments address the evolution of financial products, technology, and trading systems over the past 37 years.[10] For example, the Proposed Part 190 Amendments contain specific provisions for handling digital currencies and electronic communications.[11] Additionally, learning from the successes and failures of previous commodity broker bankruptcies, the Proposed Part 190 Amendments would give much greater discretion to the bankruptcy trustee to account for the increase in transaction execution and processing speeds as well as the surge in the volume of global trading.

Framework For Addressing How To Resolve A DCO Bankruptcy

The Proposed Part 190 Amendments would adopt—for the first time in CFTC's history—a framework for addressing the occurrence of a DCO resolution. Even though a DCO bankruptcy has never occurred, the Proposed Part 190 Amendments reflect the lessons learned from prior FCM bankruptcies and would empower bankruptcy trustees with broad discretion and bring legal certainty to a DCO bankruptcy proceeding. The CFTC believes market participants will benefit from the establishment of a predesignated plan in the unfortunate event DCO becomes insolvent.

If adopted, the Proposed Part 190 Amendments would clarify how a DCO resolution would be administered. Specifically, the Proposed Part 190 Amendments would allow for the use of a DCO's existing default, recovery, and wind-down policies and procedures. Accordingly, the bankruptcy trustee would be able to utilize existing methodologies to assist with the bankruptcy process rather than being forced to adopt a resolution plan “on the spot.” Market participants should benefit from the certainty of using existing policies and procedures as a road map for the unwinding process.

PROPOSED RULE: AMENDMENTS TO COMPLIANCE REQUIREMENTS FOR CPOS ON FORM CPO-PQR

By a unanimous vote, CFTC Commissioners voted to approve a proposed rule amending Form CPO-PQR and simplifying filing requirements.[12]

- Under the proposal, all CPOs would submit the same, shorter and simplified, Form CPO-PQR (without a Schedule B or Schedule C) on a quarterly basis (other than the schedule of investments).[13]

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- The CFTC would obtain other information from Swap Data Repositories and pair that data with a CPO's reported activity by the LEIs that would be reported on the new Form CPO-PQR.
- The new Form CPO-PQR would enable greater information sharing with the Office of Financial Research and the Financial Stability Oversight Council (FSOC) at the Department of the Treasury.
- CPOs should be aware that there are legislative efforts to expand the role and functionality of the FSOC, and the information reported on Form CPO-PQR may be reported to a more active FSOC.

Post Dodd-Frank Act: Collecting Data that Was Not Always Used

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires advisers to large private funds to file reports containing information that was deemed to be necessary and appropriate in the public interest for investor protection and for the assessment of systemic risk.[14] These reports are shared with the FSOC, as Congress expressed the belief that information regarding the size, strategies, and positions of large private funds "could be crucial to regulatory attempts to deal with a future crisis."[15] In light of the regulatory goals of the Dodd-Frank Act, the CFTC adopted Form CPO-PQR in 2012.[16] Form CPO-PQR was intended to:

10. Align the Commission's regulatory structure for CPOs with the purposes of the Dodd-Frank Act;
11. Encourage more congruent and consistent regulation of similarly situated entities among federal financial regulatory agencies, such as dually registered CPOs required to file Form PF;
12. Improve accountability and increase transparency of the activities of CPOs and the commodity pools that they operate or advise; and
13. Facilitate data collection that would potentially assist FSOC.[17]

However, as Chairman Tarbert noted, "[s]even years of experience with Form CPO-PQR … have not born out that vision"[18] because CFTC Staff have found that the "disparate, infrequent, and delayed nature of CPO reporting has made it difficult to assess the impact of CPOs and their operated pools on markets." Chairman Tarbert indicated that, in proposing the amendments to Form CPO-PQR, the credibility of the CFTC would be strengthened when "we honestly admit that our regulations ask for data that we both have not used effectively and have no intention of using going forward."[19]

Streamlined Reporting: Potential for Heightened Scrutiny

The proposed amendments are intended to streamline reporting requirements for CPOs and facilitate more information sharing with other regulators. Specifically, the proposed amendments would:

14. Eliminate the pool-specific reporting requirements in existing Schedules B and C of Form CPO-PQR, other than the pool schedule of investments;
15. Amend the information in existing Schedule A of the form to request LEIs for CPOs and their operated pools that have them and eliminate questions regarding pool auditors and marketers; and
16. Require all CPOs to file the resulting amended Form CPO-PQR quarterly, but they would also be allowed to file NFA Form PQR, a comparable form required by the NFA, in lieu of filing the revised Form CPO-PQR.[20]

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The CFTC intends to share the information collected on Form CPO-PQR with the Department of the Treasury's Office of Financial Research and FSOC. CPOs should be aware that the information reported on Form CPO-PQR can be used to initiate an audit by regulators, including the NFA.

FINAL RULE: AMENDMENTS TO PART 23 MARGIN REQUIREMENTS FOR THE ESM

The CFTC also voted unanimously to approve a final rule regarding Part 23 Margin Requirements for the ESM. The final rule codifies relief from CFTC No-Action Letter 19-22[21] and exempts registered swap dealers that do not follow the uncleared margin rules with respect to swaps entered into with the ESM.

PROPOSED RULE: AMENDMENTS TO PART 50 CLEARING REQUIREMENTS FOR CENTRAL BANKS, SOVEREIGNS, INTERNATIONAL FINANCIAL INSTITUTIONS, BANK HOLDING COMPANIES, AND COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS

The Commission also unanimously voted to approve the proposal to amend the CFTC's Part 50 rules to exempt certain entities from the clearing requirement for swaps under section 2(h)(1) of the Commodity Exchange Act. New regulations 50.75 and 50.76 would codify existing exemptions for swaps entered into with certain central banks, sovereign entities, and international financial institutions of which sovereign nations are members. New regulations 50.77, 50.78, and 50.79 would exempt swaps entered into by small bank holding companies and savings and loan holding companies whose assets total no more than US$10 billion, as well as community development financial institutions recognized by the Department of the Treasury. Other amendments would include providing a compliance schedule setting forth all past compliance dates for the 2012 and 2016 swap clearing requirement rules, in addition to various nonsubstantive, technical amendments. The proposed rule has a 60-day comment period following publication in the Federal Register.

Chairman Tarbert emphasized that the proposed Part 50 rule amendments, if adopted, will provide certainty regarding existing exemptions and reduce costs and regulatory burdens for entities that pose little or no systemic risk to the U.S. economy.[22] As a result, those amendments will support local institutions, businesses, communities, and families and further the CFTC's goals of promoting the interests of all Americans.

FINAL RULE: AMENDMENT TO PART 160 CONSUMER FINANCIAL INFORMATION PRIVACY REGULATION

Lastly, the Commission voted to approve a final rule amendment to Part 160 to restore certain consumer financial information privacy provisions that were inadvertently deleted. These inadvertently deleted provisions included the following safeguards requiring that the policies and procedures for protecting consumer financial information privacy be reasonably designed to: (i) ensure the security and confidentiality of customer records and information, (ii) protect against any anticipated threats or hazards to the security or integrity of customer records and information, and (iii) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.[23] The NFA also currently requires compliance with these provisions under the “NFA Regulatory Requirements for FCMs, IBs, CPOs, and CTAs.”[24] The

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Commissioners unanimously confirmed their support for this final rule with very few comments or questions during their discussion.

LOOKING AHEAD AND NEXT STEPS

As financial institutions respond to market volatility and the COVID-19 pandemic, regulatory developments from the CFTC that minimize compliance burdens will likely be welcomed. Market participants should carefully monitor market developments as comments are due for the proposed rules in the coming months.

The global futures and derivatives team at K&L Gates continues to follow these and other recent developments at the CFTC, including changes to the swaps trading rules, cross-border guidance, and position limits. Our futures and derivatives team stands ready to assist market participants in the navigation of these developments and the CFTC and global derivatives regulatory agenda during this period of increased market volatility.

FOOTNOTES

[1] *See* Amendments to Part 190 Bankruptcy Rules, 85 Fed. Reg. 36,000 (June 12, 2020).

[2] *See* Amendments to Compliance Requirements for Commodity Pool Operators on Form CPO-PQR, Commodity Futures Trading Comm'n, 85 Fed. Reg. 26,378 (May 4, 2020).

[3] *See* Swap Clearing Requirement Exemptions, Commodity Futures Trading Comm'n, 85 Fed. Reg. 27,955 (May 12, 2020).

[4] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 85 Fed. Reg. 27,674 (May 11, 2020).

[5] *See* Privacy of Consumer Financial Information, 85 Fed. Reg. 29,611 (May 18, 2020).

[6] See Amendments to Part 190 Bankruptcy Rules, *supra* note 1.

[7] *See* Statement of Support by CFTC Commissioner Quintenz regarding Part 190 Bankruptcy Regulations, Commodity Futures Trading Comm'n (Apr. 14, 2020).

[8] *See* MF Global Holdings Ltd. (Case No. 11-15059 (MG)).

[9] *See* Amendments to Part 190 Bankruptcy Rules, *supra* note 1.

[10] Statement of Chairman Heath P. Tarbert in Support of Long-Awaited Updates to the CFTC's Bankruptcy Regime, Commodity Futures Trading Comm'n (Apr. 14, 2020).

[11] *See* Amendments to Part 190 Bankruptcy Rules, Voting Draft 52 (Apr. 14, 2020).

[12] *See* Amendments to Compliance Requirements for Commodity Pool Operators on Form CPO-PQR, Commodity Futures Trading Comm'n, 85 Fed. Reg. 26,378 (May 4, 2020).

[13] Schedule A is required for every CPO. Part 1 of Schedule A asks for information about the CPO and part 2 of Schedule A asks for information about each individual pool that the CPO operated during the reporting period. Schedule B is required for mid-sized and large CPOs. Schedule C is required for large CPOs. Templates of these schedules are available here.

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[14] *See* Dodd-Frank Act section 404; Advisers Act section 204, 15 U.S.C. 80b-4(b)(5); see also 15 U.S.C. 80b-4(b)(1).

[15] *See* Amendments to Compliance Requirements for Commodity Pool Operators on Form CPO-PQR, Commodity Futures Trading Comm'n, 85 Fed. Reg. 26,378 (May 4, 2020).

[16] *See* Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11,252 (Feb. 24, 2012); 17 C.F.R. pt. 4 app. A; 17 C.F.R. 4.27.

[17] *See id.* at 6.

[18] Chairman Heath Tarbert, Statement of Chairman Heath P. Tarbert in Support of Revising Form CPO-PQR, Commodity Futures Trading Comm'n (Apr. 14, 2020).

[19] *See id.*

[20] *See* Amendments to Compliance Requirements for Commodity Pool Operators on Form CPO-PQR, Commodity Futures Trading Comm'n, 85 Fed. Reg. 26,378 (May 4, 2020).

[21] *See* CFTC Letter No. 19-22, (Oct. 16, 2019).

[22] *See* Statement of Chairman Heath P. Tarbert in Support of Proposed Amendments to the Part 50 Clearing Requirement, Commodity Futures Trading Comm'n (Apr. 14, 2020).

[23] *See* Privacy of Consumer Financial Information, 85 Fed. Reg. 29,611 (May 18, 2020).

[24] *See* NFA Regulatory Requirements for FCMs, IBs, CPOs, and CTAs (Jan. 2020).

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