

2021 Year in Preview: The Derivatives Forecast for Investment Managers

February 10, 2021

As we settle into the new year, we expect to see some important developments that will affect participants in the derivatives market. This Update focuses on the impact these events will have on investment advisers and recommends specific actions to take in preparation for these changes. Specifically, this Update provides information regarding the impending sunset of LIBOR, uncleared margin requirements, regulation of security-based swaps, new federal position limits for commodity futures contracts and economically equivalent swaps, and new Rule 18f-4 applicable to U.S. registered investment companies.

LIBOR Transition

In 2017, the UK Financial Conduct Authority (FCA) announced it would no longer compel or persuade banks to submit quotes for LIBOR after 2021. This initiated a sweeping transition by all market participants to adopt alternative risk-free rates.¹ In preparation for the LIBOR cessation, market participants will want to evaluate the fallback mechanics² in their existing agreements and consider implementing a transition plan to apply risk-free rates in new agreements.

Proposed Cessation Timeline

On December 4, 2020, the Intercontinental Exchange Benchmark Administrator (IBA) published a consultation seeking market input on proposed LIBOR cessation dates³ of (i) December 31, 2021, for all tenors of GBP, EUR, JPY, and CHF LIBOR and one-week and two-month tenors of USD LIBOR and (ii) June 30, 2023, for one-month, three-month, six-month, and 12-month USD LIBOR. Notwithstanding the proposed 2023 cessation for key USD LIBOR tenors, U.S. banking regulators have expressed their expectation that the use of USD LIBOR in all new transactions will cease by December 31, 2021.

ISDA 2020 IBOR Protocol

In October 2020, ISDA published its 2020 IBOR Fallbacks Protocol (the Protocol) and a Supplement to the 2006 International Swaps and Derivatives Association (ISDA) Definitions (the Supplement), both of which provide for standardized fallbacks from the relevant IBORs to a specific risk-free rate. The

¹ Risk-free replacement rates include (i) secured overnight funding rate (SOFR) for USD LIBOR, (ii) SONIA for GBP LIBOR, (iii) ESTER for EUR LIBOR, (iv) TONAR for JPY LIBOR, and (v) SARON for CHF LIBOR.

² A fallback refers to the procedure for determining a replacement reference rate in the event LIBOR (or other applicable reference rate) becomes unavailable.

³ The comment period for the consultation ended January 25, 2021. IBA intends to share the results of the consultation with the FCA and thereafter publish a public statement summarizing the results of the consultation. The summary has not been made available at the time of this writing.

Protocol will amend existing ISDA documentation and other industry master agreements (and transactions thereunder) entered into prior to January 25, 2021, between parties that have adhered to the Protocol by incorporating the new fallback provisions that will apply if the relevant IBOR rates are no longer published. All transactions entered into on or after January 25, 2021, that incorporate the 2006 ISDA Definitions will automatically incorporate the new fallback provisions set forth in the Supplement.

Preparing for the LIBOR Cessation: Recommended Action Items for Investment Managers

- *Take Inventory:* LIBOR cessation will have a significant effect on a broad array of financial instruments and asset classes, including swaps and derivatives, credit and financing agreements, corporate notes and bonds, and securitizations. We suggest taking inventory of all existing contracts with an IBOR component to identify the applicable fallback mechanic⁴ and to determine when that fallback mechanic will take effect.
- *Amend Existing Agreements:* Once all affected contracts have been identified, consider whether amendments are required to prepare for the LIBOR cessation. For derivatives contracts, dealers are strongly encouraging clients to adhere to the Protocol. Alternatively, parties can agree to bilaterally amend their derivatives documents. Participants in cash markets may have limited ability to control the amendment process but will benefit from reaching out to relevant counterparties to remain informed of their plans to implement LIBOR fallbacks in these agreements and analyze the basis risk impact these fallbacks may have on correlated investments.⁵ Clearinghouses and exchanges have begun implementing rule changes that adopt fallback provisions substantially similar to the Protocol, so most cleared swaps will fall back to the same rates as the over-the-counter (OTC) swap market.
- *Transitioning New Agreements:* As noted above, U.S. banking regulators have expressed their expectation that the use of USD LIBOR in all new transactions will cease by December 31, 2021. Investment managers should expect to see alternative rates incorporated into new agreements. To the extent any agreement entered into in 2021 references a LIBOR rate, investment managers should make certain that such agreements incorporate the fallback mechanics specified in the Supplement or otherwise incorporate AARC-recommended fallback mechanics.
- *Update Investor Documents:* Investment managers should consider any steps necessary to replace LIBOR for funds that use a benchmark referencing LIBOR to articulate a targeted

⁴ For swaps and derivatives trading, the default fallback rate is the applicable reference bank rate specified in the 2006 ISDA Definitions. In the cash markets, fallbacks are determined on a more ad hoc basis and are usually set out in the underlying contract. Typically credit and financing agreements look to an alternative base rate or prime rate, which could be costly for borrowers. Corporate bonds and notes typically refer to the last published LIBOR rate, which would have the effect of creating a fixed-rate note once LIBOR is no longer published. Finally, contracts that are silent as to the appropriate fallback or that provide for a fallback that will not produce a functional rate could lead to legal impossibility or frustration in performance of such contracts and extensive litigation.

⁵ LIBOR and SOFR are fundamentally different rates, therefore, to minimize the value transfer associated with the change in rate, SOFR must be adjusted to account for credit risk differences and term/duration differences. Credit risk differences occur because LIBOR has an embedded credit component and SOFR (as a risk-free rate) does not. Adjustment for credit risk differences will result in a spread adjustment using a five-year historical median difference between LIBOR and SOFR. The term/duration adjustment accounts for the fact that SOFR is an overnight rate and does not (yet) have an analogous term structure (e.g., one-month, three-month). In the derivatives market, to account for this difference, SOFR will be compounded in arrears over a similar tenor. The loan market is taking a different approach – the hardwired fallback language recommended by the Alternative Reference Rates Committee (AARC) is simple SOFR compounded in arrears. This will result in slightly different adjusted SOFR rates being used in the derivatives and loan markets. For derivatives transactions, Bloomberg Index Services Limited will calculate and distribute the applicable rate adjustments and the mechanics for making the applicable adjustments are included in the Supplement.

return or to calculate a hurdle for a performance fee or allocation. If LIBOR is used in the context of calculating performance compensation, the investment manager will want to determine whether it has discretion to determine a successor benchmark and take appropriate action. Finally, investment managers may wish to update fund documents to include risk factors describing the possible market disruptions that may occur due to the LIBOR transition.

- *Operational Readiness:* Investment managers will also want to consider what enhancements or modifications are needed to internal systems, including updates to controls, processes, risk valuation models, and related internal policies.

Next Compliance Dates for U.S. Uncleared Swaps Margin Rules

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) mandates margining of uncleared swaps and security-based swaps (collectively referred to herein as “uncleared swaps”), and gives the U.S. prudential regulators (the Prudential Regulators) and the Commodity Futures Exchange Commission (CFTC) jurisdiction to implement these rules. Currently, the margin rules of the Prudential Regulators (the PR Margin Rules) and the CFTC (the CFTC Margin Rules, and with the PR Margin Rules, the U.S. Margin Rules) have been adopted, and the initial margin (Reg IM) requirements of the U.S. Margin Rules (the U.S. IM Rules) are in the process of being implemented. The next two scheduled compliance dates for the U.S. IM Rules will apply to uncleared swaps entered into on or after September 1, 2021 (Phase 5) and September 1, 2022 (Phase 6).⁶

Preparing for the U.S. IM Rules: Identifying Who Is in Scope for Phase 5

End users who qualify as “financial end users” (e.g., collective investment vehicles) that face swap dealers subject to the PR Margin Rules or the CFTC Margin Rules will be in scope for Phase 5 of the U.S. IM Rules if their overall swaps trading activity exceeds an average aggregate notional amount (AANA) threshold of \$50 billion. End users with a high volume of swaps trading will want to run these calculations to determine if they are in scope for the Phase 5 deadline. The key components of the AANA calculation are as follows:

- The Phase 5 AANA calculation is based on a *daily* average aggregate notional amount of in-scope instruments (discussed below) for each business day of the observation period.
- The observation period for the Phase 5 AANA calculation is March, April, and May of 2021.
- Instruments to be included within the Phase 5 AANA calculation are CFTC-regulated “swaps,” “security-based swaps” regulated by U.S. Securities and Exchange Commission (SEC), and physically settled foreign exchange swaps and forwards, in each case, which are entered into on an uncleared basis.
- A legal entity’s AANA is required to be aggregated with the AANA any of its “affiliates” engaged in in-scope swap transactions. For this purpose, affiliation is defined by reference to accounting consolidation principles (i.e., entities that are consolidated on the same financial statements for accounting purposes).

⁶ Both the European Union (EU) and the United Kingdom (UK) have margin requirements, including with respect to initial margin, which apply directly to financial institutions and swap dealers located in those respective jurisdictions. The EU and UK initial margin requirements are not addressed in this Update but are similar (although not identical) to the U.S. IM Rules and have similar phase-in requirements as those identified in this Update with respect to the U.S. IM Rules.

Preparing for Compliance With U.S. IM Rules: Phase 5 Action Items for End Users

- *End users unsure of whether they are in scope for Phase 5:* Perform AANA calculations for all relevant funds or investment vehicles as soon as possible for the most recently concluded three-month period to determine whether any will be in scope (assuming a consistent notional amount for March, April, and May of 2021).

End users who expect to be in scope based on this calculation will want to communicate with their swap dealer counterparties as soon as possible to determine next steps for compliance with the U.S. IM Rules. There are substantial documentation and operational requirements associated with the U.S. IM Rules. End users in scope for Phase 5 will want to begin addressing these requirements now to ensure compliance by the implementation deadline.

- *End users expecting to be in scope for Phase 5:* End users certain to be in scope for Phase 5 will want to consider the following steps:
 - *Identify trading relationships likely to reach or exceed the \$50 million maximum initial margin threshold.* The CFTC and the Prudential Regulators have stated that market participants are not required to have legal documentation in place for compliance with the U.S. IM Rules until such time as the initial margin requirement for a trading relationship (including both the affiliates of the end user and the swap dealer) exceeds \$50 million.
 - *Finalize custody and Reg IM segregation documents with swap dealer counterparties and custodians.* Many Reg IM custodians have established internal deadlines well in advance of September 1, 2021, for executed custody and Reg IM segregation documents, some as soon as March 1. As a result, end users in scope for Phase 5 will want to identify their Reg IM custodian and get all required documentation in place as soon as possible.
 - *Negotiate Eligible Collateral Schedules.* Although the schedules specifying the types of collateral (Eligible Collateral Schedules) that can be posted as Reg IM are not subject to internal deadlines as stringent as those being communicated with respect to the custody and Reg IM segregation documents, negotiating Eligible Collateral Schedules can be time consuming.
 - *Negotiate Reg IM Credit Support Documentation.* The Reg IM credit support documentation (e.g., Credit Support Annexes and Credit Support Deeds) will likely be required to be completed for Phase 5 market participants later in the year but prior to September 1, 2021. As a result, the negotiation of these documents should also be prioritized accordingly.

Preparing For Phase 6

Phase 6 of the U.S. IM Rules will also require end users not in scope for Phase 5 to perform an AANA calculation, but there are some key differences between the calculations required under the PR Margin Rules and under the CFTC Margin Rules (all other aspects of the CFTC Phase 6 AANA calculation and PR Phase 6 AANA calculation remain the same)⁷:

⁷ The CFTC recently finalized amendments to the CFTC Margin Rules that have effected these changes to the CFTC Phase 6 AANA calculation. It is not known at this time whether the Prudential Regulators will also amend their rules to align with the changes finalized by the CFTC.

- *CFTC Phase 6 AANA Calculation*
 - *Calculation frequency:* The CFTC Phase 6 AANA calculation is required to be made based on *month-end* average notional amounts of in-scope instruments.
 - *Observation period:* The observation period for the CFTC Phase 6 AANA calculation is March, April, and May of 2022.
- *PR Phase 6 AANA Calculation*
 - *Calculation frequency:* Consistent with the Phase 5 AANA calculation, the PR Phase 6 AANA calculation is required to be made based on *daily* average aggregate notional amounts of in-scope instruments.
 - *Observation period:* The observation period for the PR Phase 6 AANA calculation is June, July, and August of 2021.

End users evaluating whether they will be in scope for Phase 6 of the U.S. IM Rules should perform the AANA calculations as required under the CFTC Margin Rules based on a recent three-month period and continue to monitor their AANA as needed. For those end users that determine they are likely to be in scope for Phase 6 of the U.S. IM Rules, efforts toward establishing any necessary legal documentation are likely to receive more traction with swap dealer counterparties following the Phase 5 compliance date of September 1, 2021.

Regulation of Security-Based Swaps — Preparing for the October 2021 Regulatory Rollout

Dodd-Frank gives the SEC jurisdiction over security-based swaps (SBS) and SBS market participants and requires the SEC to adopt rules to regulate this market. SBS generally include swaps based on a single security or loan (including any interest in, or on the value of, such single security or loan), swaps based on a narrow-based security index (including any interest in, or on the value of, such narrow-based security index), and single-name credit default swaps.

The SEC has now finalized its core SBS rulemakings, and beginning in October 2021 — over 10 years since the passage of Dodd-Frank — the SEC’s regulatory regime for SBS and SBS market participants will go into effect. These regulations, once they take effect, will be similar (with some material differences) to regulations issued by the CFTC with respect to “swap” transactions for which the CFTC has jurisdiction.

Preparing for Regulatory Changes in 2021: Key considerations for SBS End Users

- *Margin and Segregation:* Subject to certain limited exceptions, end users transacting swaps with nonbank dealers that register with the SEC as security-based swap dealers (SBSDs) will need to bring their trading relationships into compliance with the SEC’s margin and segregation requirements for SBS (the SEC’s Margin Regulations) as early as October 6, 2021.⁸ For the past several months, ISDA has been working with the industry to prepare SBS margin documentation that will facilitate compliance with these requirements, including “bolt-on”

⁸ We note that the margin regulations of the Prudential Regulators (discussed above) apply to SBSDs that are prudentially regulated with respect to both uncleared swaps and uncleared SBS. Compliance with variation margin requirements under the PR Margin Rules has been required since March 2017, and compliance initial margin requirements under the PR Margin Rules is being rolled out as described above. The SEC’s margin requirements differ from the prudential regulators’ margin requirements in certain respects, including that there is no concept of “material swaps exposure” for purposes of determining the applicability of the SEC’s initial margin requirements, and there is no requirement for SBSDs to post margin to their counterparties.

supplements to ISDA-published credit support documents. These standard documents should simplify the process of amending affected credit support documentation. From an operational perspective, however, transitioning from use of negotiated swaps margin rates to regulatory margin could be significant. As of the date of this Update, there are no registered SBSDs, and unfortunately, there is also some uncertainty about which SBS market participants intend to register in this capacity (and whether substituted compliance will be available for certain non-U.S. SBSDs). At this time, we consider this a development to watch. While end users transacting SBSs with nonbank dealers can expect outreach from those dealers on this topic in the coming months, some may wish to reach out to their SBS counterparties proactively to determine whether they expect to register as SBSDs and, if so, what their plans are for implementing the SEC's Margin Regulations.

- *Reporting:* SEC regulations mandate reporting of SBS to registered security-based swap data repositories (SBSDRs) and public dissemination of SBS transaction, volume, and pricing information on an anonymous basis. These requirements raise two key considerations for SBS end users. The first concern is more operational: *Who is responsible for reporting?* The second is one of transparency: *What if any concerns are raised by public dissemination of a fund's SBS positions, even if on an anonymized basis?* For end users transacting cleared SBS or uncleared SBS either on a platform or with a registered SBSD, the duty to report will fall on the clearing agency (if the SBS are clearing transactions), the platform executing the SBS (if the SBS are platform-executed SBS), or the SBSD, and the end user's obligations will be limited to notification to the extent it discovers an error in the information reported. On the issue of transparency, this could be cause for concern for some market participants. For example, a fund manager who has high short notional exposure to a specific equity via total return swap will want to consider the consequences of this position being made public. Depending on a manager's size and underlying strategy, the impact could be significant, especially given recent efforts by retail investors to enter into trades with the intent of diluting hedge fund profits in large equity exposures. Some investment advisers may choose to obtain short exposure to equities in the cash markets to maintain confidentiality of such positions. The compliance date for the SBS reporting rules is not yet known (it depends in part on when the first SBSDR that can accept transaction reports in an SBS asset class registers with the SEC), but in any event it will be *no earlier than* November 8, 2021.
- *SBSD Business Conduct Requirements:* Registered SBSDs will be required to comply with a range of business conduct requirements when transacting SBSs with their counterparties. Compliance with certain of these requirements will require SBSDs to obtain certain information, representations, and covenants from their counterparties and also to make certain disclosures to them. The compliance date for the business conduct requirements is October 6, 2021 (although the SEC has granted a five-year temporary enforcement relief period for a limited number of requirements, including certain written representation requirements and certain "special entity" elections). ISDA is in the process of preparing SBS protocols that will facilitate SBSD compliance with these requirements, including the ISDA 2021 SBS Top-Up Protocol for use by SBSDs and their counterparties that have previously entered into the ISDA 2012 and 2013 Dodd-Frank Protocols for CFTC rules and a "full" SBS Protocol for circumstances where the relevant parties have not previously entered into those protocols. As with the Dodd-Frank Protocols (with which many end users are familiar), SBSDs will require adherence to these protocols (or the execution of parallel bilateral documentation) as a condition to transacting SBS with their counterparties. ISDA has also published a "self-disclosure letter" — the ISDA U.S. Self-Disclosure Letter — intended to assist market participants with the exchange of the information necessary to determine, among other things, whether compliance

with SEC SBS regulations is required.⁹ End users transacting SBSs can expect outreach from their dealers on this topic in the coming months.

CFTC Position Limits

In October 2020, the CFTC adopted final amendments to the federal position limits regulations for commodity futures contracts and new position limits rules for economically equivalent swaps (the Position Limits Rules).¹⁰ The Position Limits Rules implement provisions of Dodd-Frank nearly a decade after Dodd-Frank was enacted. The rulemaking represents the fifth attempt by the CFTC to adopt federal position limit rules pursuant to Title VII. End users of commodity futures and swaps should carefully evaluate the Position Limits Rules to determine whether and how the rules will affect their trading as they are implemented over the next several years.

Federal position limits have been in place for many years for futures contracts and options on futures contracts on nine “legacy” agricultural commodities, including corn, wheat, and soybeans. These limits apply to positions in the spot month, any single month, and all months combined. The Position Limits Rules increase the spot-month, single-month, and all-months position limits for most of the legacy contracts.

The Position Limits Rules create new federal spot-month position limits for 16 “nonlegacy” physical commodity futures contracts, including gold, silver, natural gas, and crude oil, bringing the total contracts subject to CFTC-set position limits to 25. The Position Limits Rules do not create new single-month or all-months-combined position limits for nonlegacy contracts.

The position limits set by the futures exchanges have not changed as of the date of this Update. Market participants must adhere to both the federal and exchange-set limits. In most cases this means that the numerical limits will not decrease. However, the addition of CFTC-set position limits will increase the likelihood that a market participant that violates position limits will be subject to a CFTC enforcement act in addition to possible sanctions from the futures exchange whose position limits were violated.

The Position Limit Rules also create federal position limits on swaps that are “economically equivalent” to the futures contracts for which there are CFTC-set position limits. These new position limits may have a more substantial impact on trading than the new federal futures position limits. All of the futures contracts that will be subject to federal position limits are already subject to position limits set by the futures exchanges themselves, and in most cases those limits are currently lower than the new federal position limits. However, there have not to date been regulatory position limits for OTC commodity-based derivatives. Market participants may currently turn to the OTC markets when they reach or approach position limits in the futures markets. The new federal position limits on economically equivalent swaps will severely limit their ability to do this.

The Position Limits Rules will be phased in as follows:

- In general, the rules will become effective March 15, 2021. The aspects of the rules related to exemptions and the increased CFTC-set spot-month position limits in the nine legacy futures contracts will become effective at that time.
- The new federal speculative position limits for the 16 nonlegacy futures contracts that will be subject to federal speculative position limits for the first time will be effective January 1, 2022.

⁹ The ISDA U.S. Self-Disclosure Letter is available on ISDA’s website at <https://www.isda.org/book/isda-us-self-disclosure-letter/>.

¹⁰ Commodity Futures Trading Commission, Position Limits for Derivatives, 86 Fed. Reg. 3236 (January 14, 2021).

- Federal speculative position limits for economically equivalent swaps will be effective January 1, 2023.

Preparing for Compliance With CFTC Position Limits

Market participants that trade in swaps based on the 25 commodities to which the Position Limit Rules will apply should evaluate whether any of these swaps may be deemed “economically equivalent” and begin to implement appropriate changes to compliance procedures and contractual arrangements. Investment managers have not to date been required to monitor OTC contracts against position limits, and as a result order management systems may need to be updated to monitor trading against the new position limits.

For additional information about the Position Limits Rules, see the Sidley Update titled [“CFTC Adopts Long-Awaited Federal Position Limit Rules”](#) (December 2, 2020).

Registered Investment Companies — New Rule 18f-4 under the Investment Company Act

Investment companies subject to the Investment Company Act of 1940, including exchange traded funds, start 2021 planning for implementation of new Rule 18f-4. The new rule overhauls the framework under which registered investment companies use derivatives, replacing a longstanding transaction-by-transaction “coverage” regime in favor of a series of value-at-risk (VaR) tests that can vary according to the type of company involved. The rule’s effective date is February 19, 2021 and its compliance date is August 19, 2022. Between now and the compliance date, fund firms will be assessing the new requirements and developing appropriate internal operating and risk management procedures, including (for many firms) designation of a derivatives risk manager. Funds that are “limited derivatives users” within the meaning of the rule will be focused on ensuring compliance with the limited derivatives user exception.

For additional information about new Rule 18f-4, see the Sidley Update titled [“SEC Reproposes New Rule to Regulate Funds’ Use of Derivatives”](#) (January 6, 2020).

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