Investment Services Regulatory Update

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New Rules, Proposed Rules and Guidance

Division of Investment Management Issues Guidance Regarding Gifts and Entertainment under Section 17(e)(1)

In February 2015, the staff of the Division of Investment Management of the SEC published a Guidance Update reminding mutual fund industry participants of the conflicts of interest that arise when investment adviser personnel accept gifts or entertainment from persons doing business, or hoping to do business, with a fund.

Section 17(e)(1) of the 1940 Act generally prohibits affiliated persons of a fund (e.g., an investment adviser or its personnel) from accepting any sort of compensation (other than regular salary or wages from the fund) for the purchase or sale of property to or for the fund if the affiliated person is acting as agent for the fund. The staff reaffirms its previous interpretation that compensation under Section 17(e)(1) includes gifts and entertainment. The staff notes that the receipt of gifts or entertainment by fund affiliates should be addressed in the fund's compliance policies and procedures required by Rule 38a-1 under the 1940 Act. The staff suggests that the particular content of a fund's policies and procedures concerning the receipt of gifts and entertainment will depend on the nature of the adviser's business. However, the staff cites a blanket prohibition on receiving gifts or entertainment or use of a pre-clearance mechanism for the acceptance of gifts or entertainment as possible measures to address the Section 17(e)(1) prohibition.

The Guidance Update is available at www.sec.gov/investment/im-guidance-2015-01.pdf.

SEC Proposes Rules for Disclosure of Hedging by Employees, Officers and Directors

On February 9, 2015, the SEC proposed amendments to its proxy rules to implement Section 955 of the Dodd-Frank Act. Section 955 added a new Section 14(j) to the Exchange Act that directs the SEC to require by rule each issuer to disclose in any proxy or consent solicitation material for an annual meeting of shareholders whether any employee or member of the board of directors of the issuer is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities either granted to the employee or director by the issuer as part of the compensation of the employee or director, or held, directly or indirectly, by the employee or director.

The SEC proposes to implement Section 14(j) by adding a new paragraph (i) to Item 407 of Regulation S-K to require companies to disclose in proxy or information statements with respect to the election of directors whether they permit any employees (including officers) or directors to hedge their company's securities by engaging in transactions with the economic consequences comparable to the financial instruments specified in Section 14(j). With respect to registered investment companies, the SEC proposes that the new rules apply only to closed-end funds that are listed and registered on a national securities exchange because they typically hold annual meetings to elect directors and hedging transactions might be more likely with listed closed-end funds, which often trade at a discount, than with open-end funds or exchange-traded funds. The SEC stated that the hedging information may be important to the voting decision of an investor when evaluating fund directors, including considering whether directors may be more or less incentivized as a result of holding shares to seek to decrease a fund's discount. The SEC also noted that officers and directors of listed closed-end funds are already required to report hedging transactions under Section 16(a) of the Exchange Act.

Comments on the proposed amendments are due by April 20, 2015.

SEC Extends Temporary Rule Regarding Adviser Principal Trades

On December 17, 2014, the SEC adopted an amendment to Rule 206(3)-3T to extend the Rule's expiration date by two years until December 31, 2016. The temporary Rule provides an alternative method for investment advisers who are also broker-dealers to comply with Section 206(3) of the Advisers Act, which requires an adviser to obtain client consent prior to engaging in a principal transaction with the client. Rule 206(3)-3T was initially adopted on September 24, 2007 in response to a federal appeals court decision that vacated Rule 202(a)(11)-1 of the Advisers Act, which allowed registered broker-dealers to offer fee-based accounts without being regulated as investment advisers. Pursuant to Rule 206(3)-3T, if an adviser enters into a principal trade with a client, the adviser will be deemed to comply with Section 206(3) if the adviser, among other things: (1) obtains written, revocable consent from the client prospectively authorizing principal trades; (2) provides written prospective disclosure regarding the conflicts arising from principal trades; (3) provides certain disclosures, either oral or written, and obtains client consent prior to each principal trade; (4) provides the client with an annual report on all principal transactions with that client; and (5) sends confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction. The Rule applies only to non-discretionary accounts of investment advisers who are also registered as broker-dealers and the accounts also must be brokerage accounts subject to the Exchange Act. The Rule applies to all accounts meeting the above requirements, whether or not they were previously fee-based brokerage accounts.

The SEC made no changes to Rule 206(3)-3T other than the extension of its expiration date. The SEC stated that the extension was necessary to provide sufficient protection to advisory clients while the SEC continues to consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers.

Other News

SEC and FINRA Issue Results of Cybersecurity Examinations

On February 3, 2015, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert providing summary observations derived from the staff's sweep examinations of over 100 registered broker-dealers and investment advisers that were undertaken to assess the cybersecurity practices and preparedness of such firms (the Cybersecurity Examination Initiative). On the same day, FINRA published a detailed, 46-page Report on Cybersecurity Practices identifying effective practices for dealing with cybersecurity threats, a product of its own 2014 targeted examinations of member firms and related initiatives, including a 2011 cybersecurity survey of its registered broker-dealers.

OCIE Risk Alert

In implementing the Cybersecurity Examination Initiative, OCIE staff interviewed key personnel and evaluated information and materials from 57 registered broker-dealers and 49 registered investment advisers[1] relating to the firms' practices for: identifying cybersecurity-related risks; establishing cybersecurity governance, including policies, procedures and oversight processes; identifying and responding to risks relating to service providers, vendors and other third parties; safeguarding network infrastructure and information; identifying and managing risks associated with remote access to client information and funds transfer requests; and uncovering unauthorized activity. The Risk Alert states that the staff's inquiries and document reviews were "designed to discern basic distinctions among the level of preparedness of the examined firms."

Notable observations in the Risk Alert include (figures pertain to examined firms):

- 88% of broker-dealers and 74% of investment advisers reported cyber-attacks directly or through one or more vendors, the majority of which arose from malware and fraudulent emails.
- 93% of broker-dealers and 83% of the investment advisers have adopted written information security policies.
- The written information policies and procedures of "only a small number" of broker-dealers (30%) and investment advisers (13%) contain provisions addressing how firms determine whether they are responsible for client losses associated with cyber incidents; even fewer of the broker-dealers (15%) and advisers (9%) offer security guarantees to protect clients against losses related to such incidents.
- 88% of the broker-dealers and 53% of the investment advisers reference and/or incorporate published cybersecurity risk management standards in their information security policies, such as those of the National Institute of Standards and Technology, the International Organization for Standardization, and the Federal Financial Institutions Examination Council.
- The "vast majority" of the broker-dealers (93%) and investment advisers (79%) conduct periodic risk assessments on a firm-wide basis to detect cybersecurity threats, weaknesses and potential business consequences, and use these assessments to establish their cybersecurity policies and procedures.
- Although most of the broker-dealers (84%) require cybersecurity risk assessments of vendors with access to their firms' networks, only 32% of the investment advisers have such requirements for vendors. A large majority (72%) of the broker-dealers incorporate requirements relating to cybersecurity in vendor contracts, but only 24% of investment advisers do.
- Almost all broker dealers (98%) and investment advisers (91%) make use of data encryption in some form.
- A majority (58%) of broker-dealers maintain insurance that covers losses and expenses attributable to cyber security incidents, but only 21% of investment advisers do.
- The Risk Alert focuses more on the existence of cybersecurity controls, rather than their quality, noting that the exams "did not include reviews of technical sufficiency of the firms' programs." The Risk Alert cautions that OCIE staff is "still reviewing the information [obtained in the sweep exams] to discern correlations between the examined firms' preparedness and controls and their size, complexity, or other characteristics." Citing OCIE's announced examination priorities for

1 Appendices to the Risk Alert provide breakdowns of the types of broker-dealers and advisers examined. Notably, of the total assets under management of the investment advisers examined, only 2% was accounted for by registered investment companies they advise, with the majority of clients categorized as "Diversified/Institutional."

2015, the Risk Alert states that "OCIE will continue to focus on cybersecurity using risk-based examinations."

FINRA Report on Cybersecurity Practices

FINRA's 2014 cybersecurity examination of registered broker-dealers had four primary objectives: (1) to better understand the types of cybersecurity threats that are relevant to firms; (2) to increase understanding of "firms' risk appetite, exposure and major areas of vulnerabilities in their information technology systems"; (3) to assess firms' processes and procedures for managing these threats; and (4) to share observations and findings with member firms. The FINRA Report provides detailed discussions of firm practices using selected case studies, and offers critical guidance for firms to develop or advance their cybersecurity programs in light of the "threat landscape," in particular the three top cybersecurity threats identified by broker-dealers: hackers attempting to penetrate firm systems, insiders compromising firm or client data and operational risks.

The FINRA Report lists key principles and effective cybersecurity practices, including the following:

- Firms should have a sound governance framework with sound leadership, including direct engagement by board-level and senior-level management on cybersecurity issues.
- Firms should conduct regular, comprehensive risk assessments of cybersecurity threats they face, including external and internal threats and asset vulnerabilities.
- Firms should use technical controls to protect firm software and hardware based on the circumstances of the firm. Controls may include identity and access management, data encryption, and penetration testing.
- Firms should develop, implement, and test incident response plans, and assign staff roles and responsibilities for responding to cybersecurity incidents.
- Firms should incorporate strong due diligence procedures throughout the lifecycle of relationships with vendors who access sensitive firm or client information.
- Firms should train staff to reduce the probability of cyberattacks, using information from the firm's loss incidents, risk assessment process and threat intelligence gathering.
- Firms should collaborate through intelligence-sharing opportunities to protect the industry from cyber threats.
- Firms should evaluate cyber insurance to manage the risks associated with cybersecurity threats, and periodically review the scope and terms of this coverage. Importantly, the policy should cover the specific types of risk that may be exposed within the firm. Firms without coverage should evaluate the cost and benefits of available coverage options to manage the financial impact of potential cybersecurity events.

The OCIE Risk Alert is available at www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf

The FINRA Report is available at www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p602363.pdf

OCIE Releases 2015 Examination Priorities

On January 13, 2015, OCIE announced that its examination priorities for 2015 will focus on three thematic areas: protecting retail investors; assessing market-wide risks; and the use of data analytics to identify illegal activities.

The staff noted that retail investors are being offered an increasingly complex and evolving set of investment options, including products and services that were previously considered "alternative" or "institutional." As a result of this trend, the staff identified the following examination initiatives, among others, for 2015:

- *Alternative Funds*. The staff will assess funds offering alternative investments and using alternative investment strategies, including: (1) their leverage, liquidity, and valuation policies and procedures; (2) factors relevant to the adequacy of the funds' internal controls; and (3) the manner in which such funds are marketed.
- *Fixed Income Funds*. The staff will continue to monitor whether funds with significant exposure to interest rate increases have implemented compliance policies and procedures and controls sufficient to ensure that fund disclosures are not misleading and are consistent with fund investment and liquidity profiles.
- *Fee Selection and Reverse Churning*. The staff noted that financial professionals are increasingly operating as investment advisers or as dually registered investment advisers/broker-dealers, rather than solely as broker-dealers, which often leads to a variety of available fee structures. Where an adviser has multiple fee arrangements, the staff will focus on recommendations of account types at the inception of the arrangement and thereafter, including fees charged, services provided and applicable disclosure about such relationships.
- *Sales Practices*. The staff will assess whether advisers are using improper or misleading practices when recommending the movement of retirement assets from employer-sponsored defined contribution plans into other investments and accounts, with a focus on those recommendations that pose greater risks and/or will result in higher fees.

The staff also announced certain market-wide risk initiatives that will examine structural risks and trends involving multiple firms or entire industries, including the following:

- *Cybersecurity*. The staff will continue its efforts to examine broker-dealers' and investment advisers' cybersecurity compliance and controls and will expand the initiative to include transfer agents.
- *Large Firm Monitoring*. The staff will continue to monitor the largest U.S. broker-dealers and advisers with the objective of assessing risks at individual firms and maintaining early awareness of industry-wide developments.
- *Clearing Agencies*. The staff will continue to employ a risk-based approach while conducting annual examinations of all clearing agencies designated systemically important.

The staff noted that OCIE has made significant enhancements to its data analytic capabilities over the last few years that enable more efficient and effective analysis on firms that are potentially engaged in fraudulent and/or illegal activity. The staff will use its data analytic capabilities for the following initiatives, among others, in 2015:

- *Excessive Trading*. The staff will continue to analyze data obtained from clearing brokers to identify and examine introducing brokers and registered representatives that appear to be engaged in excessive trading.
- *Anti-Money Laundering*. The staff will use its analytic capabilities to continue to examine clearing and introducing broker-dealers' AML programs, focusing on firms that did not file (or filed late/incomplete) suspicious activity reports and programs that allow customers to deposit and withdraw cash and/or provide customers direct access to the markets from higher-risk jurisdictions.

In addition to the thematic areas of focus above, the staff also announced the following 2015 examination priorities:

- *Never-Before Examined Investment Companies*. The staff will conduct focused, risk-based examinations of registered investment companies that have not yet been examined
- *Proxy Services*. The staff will examine how select proxy advisory service firms make recommendations on proxy voting and how they disclose and mitigate potential conflicts of interest, as well as how investment advisers comply with their fiduciary duty in voting proxies on behalf of investors.

For a complete list of 2015 Examination Priorities, see www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf.

ICI and IDC Issue White Paper on Funds' Use of Proxy Advisory Firms

In January 2015, the ICI and IDC issued a paper, "Report on Funds' Use of Proxy Advisory Firms," to assist boards and advisers in understanding and fulfilling their responsibilities with respect to proxy voting and the use of proxy advisory firms. The paper provides an overview of proxy advisory firm services, board oversight of proxy advisory firms, adviser due diligence and oversight of proxy advisory firms, and other miscellaneous considerations related to the use of proxy advisory firms. The paper recognizes that funds and advisers receive different types and levels of services from proxy advisory firms, that there is no single set of best practices for oversight of proxy advisory firms, practices continue to evolve, and that oversight of proxy advisory firms should be developed in a manner that complements the structure and practices of the board and adviser where relevant.

Proxy Advisory Firm Services

According to the paper, there are a wide range of services provided by proxy advisory firms that advisers may find useful in carrying out their proxy voting responsibilities. These services include: (1) assisting with the administrative tasks associated with proxy voting, such as keeping track of meeting dates and voting instructions, executing proxies in accordance with clients' instructions, generating voting reports, providing coverage and translation services with respect to foreign issuers, and compiling information for funds' annual proxy voting filings with the SEC on Form N-PX; (2) analyzing, providing research, and making voting recommendations, which advisers may take into account when deciding how to vote; (3) providing research and commentary on trends in prior and upcoming proxy seasons; (4) assisting with the formulation of and amendments to proxy voting guidelines; and (5) helping advisers mitigate conflicts of interest in voting proxies.

Board Oversight of Proxy Advisory Firms

As stated in the paper, a board typically delegates to the adviser the day-to-day oversight of the proxy advisory firm and the board may rely on the adviser to report to the board on the proxy advisory firm's performance. The paper notes that the topics addressed in board reports as well as their frequency vary and generally depend on the level and types of services provided. According to the paper, topics for inclusion in board reports might include: (1) a list or types of services offered by the proxy advisory firm and those services being used by the adviser; (2) the adviser's processes for overseeing the proxy advisory firm, including the type of information the adviser receives; (3) the adviser's assessment of the proxy advisory firm's capacity and competency to assist the adviser with proxy voting functions on behalf of the fund; (4) any material changes or events regarding the proxy advisory firm; and (5) updates of other pertinent information, such as the proxy advisory firm's guidelines and how the adviser uses the firm. The paper also notes that, in some situations, proxy advisory firms may make presentations at board meetings to educate the board about their services.

Adviser Due Diligence and Adviser Oversight of Proxy Advisory Firms

As the paper discusses, an adviser's oversight of proxy advisory firms is broadly similar to its oversight of any other service provider it may hire to assist it in carrying out a function that it has undertaken to perform. The paper notes that the adviser's oversight program and the adviser's due diligence efforts thereunder should be documented, will depend on the particular services provided and as an overarching principle, when selecting a proxy advisory firm, the adviser should consider the firm's capacity and competency to assist as well as the anticipated costs and benefits. The paper stresses that the adviser may wish to consider or evaluate additional factors as part of an initial due diligence review based on the services to be provided. The paper notes that, after an adviser has completed its initial due diligence and hired the proxy advisory firm, the adviser should continue to exercise ongoing oversight, which should occur no less frequently than the annual review of the adviser's own proxy voting policies and procedures. The paper recognizes that the adviser may choose any number of methods to keep apprised of significant developments affecting its business relationship with the proxy advisory firm, such as using recurring reviews, information requests or communications with the firm.

The paper also stresses that the adviser, subject to board approval, may want to formulate and maintain proxy voting guidelines in order to help ensure consistency and protect against potential conflicts of interest, and noted that, in many cases, the adviser adopts the proxy voting firm's standard guidelines. The paper notes that, irrespective of a proxy advisory firm's involvement, the proxy voting guidelines should reflect the adviser's and board's views about how to act in the best interest of the fund and that the adviser and board should review the guidelines at least annually. The paper recognizes that proxy voting guidelines alone, no matter how detailed, will not always yield obvious voting decisions and that with these case-by-case evaluations, many fund advisers use proxy advisory firms' research and recommendations as one resource. The paper notes that an adviser may wish to assess a proxy advisory firm's research capabilities and voting recommendations and may also want to evaluate potential conflicts of interest to which a proxy advisory firm may be subject, with these evaluations being undertaken at least annually. The paper stresses that an adviser should always consider whether the proxy advisory firm can make recommendations that are in the best interest of the fund.

The ICI/IDC paper is available at www.ici.org/pdf/pub_15_proxy_advisory_firms.pdf.

SEC Chair and FSOC Comment on Asset Management Regulation and Systemic Risk

In a December 11, 2014 speech, SEC Chair Mary Jo White described three initiatives that the SEC staff has been working on to address fund portfolio composition risks and operational risks. Similarly, the following week on December 18, 2014, the Financial Stability Oversight Council (FSOC) voted to issue a notice inviting public comment regarding various matters affecting the asset management industry, including liquidity and redemptions, leverage, operational risk and the failure of an asset manager.

The first SEC initiative discussed by Ms. White focuses on enhanced data reporting for investment advisers and funds. She stated that the SEC staff is developing recommendations to enhance reporting with respect to fund use of derivatives, fund liquidity and valuation of portfolio holdings and securities lending practices.

Second, Ms. White discussed the need for funds to have controls in place to identify and manage risks, including with regard to liquidity management and the use of derivatives. She stated that the SEC staff is considering whether broad risk management programs should be required for mutual funds and ETFs to address such risks.

The final initiative described by Ms. White would require investment advisers to create transition plans to prepare for major business disruptions. Ms. White also noted that the SEC staff is considering ways to implement the new requirements for annual stress testing by large investment advisers and funds as required by the Dodd-Frank Act.

Ms. White also discussed systemic risk, noting that any changes undertaken by the SEC may affect the entire financial system, and stating that the work of FSOC and the SEC in this area is complementary. The following week, FSOC issued a notice requesting comments on systemic risks posed by products and activities in the asset management industry. FSOC acknowledged the SEC's initiatives as outlined by Ms. White.

The FSOC notice requests comments on the following issues:

- The extent to which redemption rights and risks in pooled investment vehicles could influence investor behavior and affect the stability of the financial system;
- The ways in which the use of leverage by investment vehicles could increase the potential for forced asset sales, or expose lenders or other counterparties to losses or unanticipated market risks, and the extent to which these risks may have implications for U.S. financial stability;
- Operational risks in the asset management industry, including those associated with the transfer of client assets between asset managers and risks that may arise when multiple asset managers rely on one or a limited number of third parties to provide important services, such as asset pricing and valuation or portfolio risk management; and
- The effect the failure or closure of an asset manager, investment vehicle or an affiliate might have on the financial markets or the economy.

The full text of Ms. White's remarks are available at www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VKwXs5h0y_A.

The FSOC notice is available at www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf.

Litigation and Enforcement Actions

SEC Settles Charges Against Adviser for Failure to Maintain Fund Assets with Qualified Custodian and Other Compliance Violations

On February 12, 2015, the SEC announced that Water Island Capital LLC, an investment adviser to several alternative mutual funds, had agreed to pay a $50,000 penalty to settle SEC charges that it caused the funds it managed to violate Section 17(f) of the 1940 Act by failing to maintain certain fund assets with a qualified custodian. Specifically, the SEC order found that Water Island Capital failed to ensure that approximately $247 million in cash collateral related to fund derivative trades was maintained with the funds' custodial bank; instead, the cash collateral was held by broker-dealer counterparties.

The SEC also found that Water Island Capital failed to implement the funds' directed brokerage policies and procedures, which required the firm to create and maintain an approved list of executing brokers for the funds, as well as to monitor the funds' compliance with the directed brokerage policies and procedures. The SEC order stated that Water Island Capital failed to create the list and failed to maintain documentation reflecting monitoring of the funds' directed brokerage policies and procedures.

SEC Settles with Investment Advisory Firm over Claims of False Performance Advertising

On December 22, 2014, the SEC settled charges against investment advisory firm, F Squared Investments, Inc., in connection with false performance advertising of F Squared's AlphaSector product. The SEC also charged the firm's co-founder and former CEO, Howard Present, since according to the SEC, he was responsible for F Squared's advertising materials and also certified the accuracy of filings regarding AlphaSector with the SEC.

According to the SEC's order, F Squared advertised a seven-year track record for AlphaSector's investment strategy using data derived through backtesting (i.e., applying a model to historical market data to generate hypothetical performance for prior periods), although F Squared advertised the investment strategy as "not backtested." The SEC also alleged that the data used to calculate the track record contained a substantial performance calculation error that inflated the results by approximately 350%.

F Squared consented to the entry of the order finding that it violated various sections of the Advisers Act and the rules thereunder. The order also found that F Squared aided and abetted and caused certain mutual funds sub-advised by F Squared to violate Section 34(b) of the 1940 Act. F Squared agreed to retain an independent compliance consultant and pay disgorgement of $30 million and a penalty of $5 million.

Derivatives Markets

ISDA Recommends Measures to Enhance Derivatives Trade Reporting and Transparency

On February 26, 2015, the International Swaps and Derivatives Association (ISDA) outlined measures to further improve regulatory transparency and trade reporting of derivative transactions. Among other measures, ISDA recommended that regulators worldwide implement consistent reporting requirements for common trade data and that unique global identifiers for legal entities, product types and trades be "expanded as necessary" and "adopted across reporting regimes." ISDA also recommended that global regulators address laws and regulations that prevent the sharing of derivatives of trade data across geopolitical boundaries.

The report is available at www2.isda.org/news/isda-outlines-key-principles-for-further-improving-regulatory-transparency-and-derivatives-trade-reporting

SEC Adopts Rules Regarding Security-Based Swap Data Repositories

On January 14, 2015, the SEC adopted two rules requiring security-based swap depositories (SB-SDR) to register with it, and enumerating such SB-SDRs' reporting and public dissemination requirements. The SEC also proposed rule amendments and guidance related to the reporting and public distribution of data related to security-based swap transactions. Among other measures, all security-based swaps involving US persons or registered security-based swap dealers would have to be reported to an SB-SDR within 24 hours after execution; the rules do not require real-time reporting. SB-SDRs must also establish independent compliance functions, with only boards of directors having the authority to appoint, determine the level of compensation for and remove chief compliance officers, and requiring chief compliance officers to prepare an annual compliance report. Finally, the rules establish a hierarchy related to the reporting of required information among the different types of parties to a security-based swap transaction (e.g., priority for security-based swap dealers).

The new rules will become effective 60 days after they are published in the Federal Register. Persons subject to the new rules governing the registration of SB-SDRs must comply with them by 365 days after they are published in the Federal Register.

Relief for Commercial End-Users and Financial Cooperatives from Margin Requirements for Non-Cleared Swaps

On January 12, 2015, President Obama signed into law the Business Risk Mitigation and Price Stabilization Act of 2015, which amends the Commodity Exchange Act to exempt from the rules of prudential regulators for swap dealers and major swap participants with respect to initial and variation margin requirements for swaps not cleared by a registered derivatives clearing organization (1) non-financial entities entering into swaps to hedge and mitigate commercial risk (commercial end-users), (2) affiliates acting on behalf of non-financial entities that use swaps to hedge or mitigate the commercial risk of such entities or another affiliate that is not a financial entity (exempt affiliates), and (3) cooperatives that meet certain regulatory parameters (exempt cooperatives). The law also amends the 1934 Act regarding registration and regulation of security-based swap dealers and major security-based swap participants, to exempt from initial and variation margin requirements for swaps not cleared by a registered derivatives clearing organization a security-based swap in which one of the counterparties qualifies for a specified exception from clearing requirements or satisfies certain criteria governing the treatment of affiliates.

The Act is available at www.congress.gov/bill/114th-congress/house-bill/26.

CFTC Considering Clearing Mandate for Foreign Exchange Non-Deliverable Forwards

In December 2014, the Foreign Exchange Markets Subcommittee (FEMS), a subcommittee of the CFTC, issued a report to the CFTC Global Markets Advisory Committee (GMAC) regarding a prospective clearing mandate for foreign exchange non-deliverable forwards (FX NDFs). In the report, FEMS recommends that, should the CFTC decide to proceed with a US clearing mandate for NDFs, that mandate should include a clear timeline and method of implementation to ensure that market participants have appropriate opportunity to address the issues outlined in the report. According to FEMS, the appropriateness of a clearing mandate is critically linked to the objective of mitigating systemic risk, consistent with the goals of the G20. While a CFTC clearing mandate for FX NDFs would result in a system-wide reduction of counterparty credit risk, it may not reduce systemic risk in the financial system given the FX NDF market's small size (about 2% of the overall foreign exchange market) and short-dated tenor (over 90% of volumes are transacted in tenors of less than three months). The FX NDF market will represent the third asset class to be moved under rules for clearing and execution agreed to by the G20, after rates and credit derivatives have migrated towards central clearing over the past few years.

The report is available at www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/gmac_fxndfmandate122214.pdf.

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