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Derivatives, Legislative and Regulatory Weekly Update (February 2, 2024)

Client Alert | February 2, 2024

From the Derivatives Practice Group: *ISDA and ESMA were particularly active this week, releasing several global reports.* **New Developments**

- **CFTC's Energy and Environmental Markets Advisory Committee to Meet February 13**. On January 30, 2024, CFTC Commissioner Summer K. Mersinger, sponsor of the Energy and Environmental Markets Advisory Committee (EEMAC) announced the EEMAC will hold a public meeting from 9:00 a.m. to 11:30 a.m. (MST) on Tuesday, February 13 at the Colorado School of Mines in Golden, Colorado. The CFTC stated that at this meeting, the EEMAC will explore the role of rare earth minerals in transitional energy and electrification, including the potential development of derivatives products to offer price discovery and hedging opportunities in these markets. Additionally, the meeting will include a presentation and discussion on the federal prudential financial regulators proposed rules implementing Basel III and the implications for and impact on the derivatives market. Finally, the two EEMAC subcommittees will offer an update on their continued work related to traditional energy infrastructure and metals markets. [NEW]
- **CFTC Cautions the Public to Beware of Artificial Intelligence Scams**. On January 25, the CFTC's Office of Customer Education and Outreach issued a customer advisory warning the public about Artificial Intelligence (AI) scams. *Customer Advisory: AI Won't Turn Trading Bots into Money Machines* explains how the scams use the potential of AI technology to defraud investors with false claims that entice them to hand over their money or other assets to fraudsters who misappropriate the funds and deceive investors. The advisory warns investors that claims of high or guaranteed returns are red flags of fraud and that strangers promoting these claims online should be ignored. The CFTC stated that the advisory is intended to help investors identify and avoid potential scams and includes a reminder that AI technology cannot predict the future. It also lists four items investors may consider to avoid such scams: researching the background of a company or trader, researching the history of the trading website, getting a second opinion, and knowing the risks associated with the underlying assets.
- **CFTC Staff Releases Request for Comment on the Use of Artificial Intelligence in CFTC-Regulated Markets**. On January 25, the CFTC's Divisions of Market Oversight, Clearing and Risk, Market Participants, and Data and the Office of Technology Innovation issued a request for comment (RFC) in an effort to better inform them on the current and potential uses and risks of AI in the derivatives markets that the CFTC regulates. The RFC seeks comment on the definition of AI and its applications, including its use in trading, risk management, compliance, cybersecurity, recordkeeping, data processing and analytics, and customer interactions. The RFC also seeks comment on the risks of AI, including risks related to market manipulation and fraud, governance, explainability, data quality, concentration, bias, privacy and confidentiality and customer protection. The CFTC indicated that staff will consider the responses to the RFC in analyzing possible future actions by the CFTC, such as new or amended guidance, interpretations, policy statements, or regulations. Comments will be accepted until

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April 24, 2024.

- **CFTC Seeks Public Comment on Proposed Capital Comparability Determination for Swap Dealers Subject to Supervision by the UK Prudential Regulation Authority**. On January 24, the CFTC solicited public comment on a substituted compliance application requesting that the CFTC determine that certain CFTC-registered nonbank swap dealers located in the United Kingdom may satisfy certain Commodity Exchange Act capital and financial reporting requirements by being subject to, and complying with, comparable capital and financial reporting requirements under UK laws and regulations. The Institute of International Bankers, the International Swaps and Derivatives Association, and the Securities Industry and Financial Markets Association submitted the application. In connection with the application, the CFTC also solicited public comment on a proposed comparability determination and related order providing for the conditional availability of substituted compliance to CFTC-registered nonbank swap dealers under the UK Prudential Regulation Authority's prudential supervision. The comment period will be open until March 24, 2024.
- **BGC Group Announces Approval for FMX Futures Exchange**. On January 22, BGC Group, Inc. (BGC) announced that its FMX Futures Exchange (FMX) received approval from the CFTC to operate an exchange for U.S. Treasury and SOFR futures. BGC will combine their Fenics UST cash Treasury platform and FMX to work across the CME's U.S. interest rate complex. FMX is party to a clearing agreement with LCH SwapClear, a holder of interest rate collateral, which it indicated will allow for portfolio margining across rates of risk and provide for margin efficiencies and effective risk management.
- **CFTC Cancels Open Meeting**. On January 20, the CFTC cancelled its open meeting scheduled for January 22. According to the CFTC, Tthe following matters will be resolved through the CFTC's seriatim process:
    - Notice of Proposed Order and Request for Comment on an Application for a Capital Comparability Determination Submitted on behalf of Nonbank Swap Dealers subject to Capital and Financial Reporting Requirements of the United Kingdom and Regulated by the United Kingdom Prudential Regulation Authority,
    - Proposed Rule: Requirements for Designated Contract Markets and Swap Execution Facilities Regarding Governance and the Mitigation of Conflicts of Interest Impacting Market Regulation Functions.
- **CFTC Designates IMX Health, LLC as a Contract Market**. On January 18, the CFTC announced it has issued an Order of Designation to IMX Health, LLC, granting it designation as a contract market (DCM). IMX Health is a limited liability company registered in Delaware and headquartered in Chicago, Illinois. The CFTC issued the order under Section 5a of the Commodity Exchange Act (CEA) and CFTC Regulation 38.3(a). The CFTC determined IMX Health demonstrated its ability to comply with the CEA provisions and CFTC regulations applicable to DCMs. With the addition of IMX Health, there will be 17 DCMs.
- **CFTC Issues Staff Letter No. 24-01**. On January 16, the CFTC issued Staff Letter No. 24-01, granting an exemption to LCH SA from the requirements of Regulation 1.49(d) to permit LCH SA to hold customer funds at the Banque du France. Additionally, the CFTC confirmed that it would not recommend enforcement action against LCH SA for failing to obtain, or provide the Commission with, an executed version of the template acknowledgment letter set forth in Appendix B to Regulation 1.20 , as required by Regulations 1.20(g)(4) and 22.5, for customer accounts maintained at the Banque de France.

New Developments Outside the U.S.

- **ESAs Recommend Steps to Enhance the Monitoring of BigTechs' Financial**

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Services Activities. On February 1, the European Supervisory Authorities (ESAs) published a Report setting out the results of a stock take of BigTech direct financial services provision in the EU. The Report identifies the types of financial services currently carried out by BigTechs in the EU pursuant to EU licenses and highlights inherent opportunities, risks, regulatory and supervisory challenges. The stock take showed that BigTech subsidiary companies currently licensed to provide financial services pursuant to EU law mainly provide services in the payments, e-money and insurance sectors and, in limited cases, the banking sector. However, the ESAs have yet to observe their presence in the market for securities services. To further strengthen the cross-sectoral mapping of BigTechs' presence and relevance to the EU's financial sector, the ESAs propose to set-up a data mapping tool. The ESAs explained that this tool is intended to provide a framework that supervisors from the National Competent Authorities would be able to use to monitor on an ongoing and dynamic basis the BigTech companies' direct and indirect relevance to the EU financial sector. [NEW]

- **ESMA Publishes Risk Monitoring Report**. On January 31, the European Securities and Markets Authority (ESMA) published its first risk monitoring report of 2024, where it sets out the key risk drivers currently facing financial markets. Beyond the risk drivers, ESMA's report provides an update on structural developments and the status of key sectors of financial markets, during the second half of 2023. The report considers structural developments in various areas, including market-based finance, sustainable finance, securities markets, and asset management. [NEW]
- **ESMA Consults on Reverse Solicitation and Classification of Crypto Assets as Financial Instruments Under MiCA**. On January 29, ESMA, published two Consultations Papers on guidelines under Markets in Crypto Assets Regulation (MiCA), one on reverse solicitation and one on the classification of crypto-assets as financial instruments. ESMA is seeking input on proposed guidance relating to the conditions of application of the reverse solicitation exemption and the supervision practices that National Competent Authorities may take to prevent its circumvention. ESMA is also seeking input on establishing clear conditions and criteria for the qualification of crypto-assets as financial instruments. [NEW]
- **EC Publishes Amendments to Clearing Obligation Scope in Light of Benchmark Reform**. On January 22, the delegated regulation amending the regulatory technical standards (RTS) defining the scope of the clearing obligation (CO) was published in the EU Official Journal, with the amended requirements due to enter into force 20 days after publication. The European Commission (EC) stated that the amendments were introduced in light of the transition to the TONA and SOFR benchmarks referenced in certain over-the-counter derivatives contracts. The amendment to the scope of the CO consists of introducing TONA overnight indexed swaps (OIS) with maturities up to 30 years and extending the SOFR OIS class subject to the CO to maturities up to 50 years. The adoption follows the publication by ESMA, on February 1, 2023, of its final report on changes to the scope of the CO and the derivatives trading obligations (DTO) in light of the benchmark transition, following a consultation last year, to which ISDA responded on September 30, 2022. This ESMA report included two draft amending RTS: one draft RTS amending the scope of the CO and one draft RTS amending the scope of the DTO. The delegated regulation containing the RTS amending the scope of the CO has now been published. The RTS on the DTO has not yet been adopted.

New Industry-Led Developments

- **ISDA Response on Anti-Greenwashing Rules**. On January 26, ISDA submitted a response to the UK Financial Conduct Authority's consultation on *xGC23/3: Guidance on the Anti-Greenwashing Rule*. In the response, ISDA highlights that

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actual or perceived misrepresentation of sustainability features may have a detrimental impact on investor and consumer perceptions of sustainable finance products, and ISDA supports efforts to enhance trust in the market. ISDA considers that sustainability-linked derivatives, environmental, social and governance derivatives and voluntary carbon credits fall within the scope of the rule. [NEW]

- **Joint Response to EC on BMR**. On January 23, ISDA, the Global Financial Markets Association and the Futures Industry Association (FIA) submitted a joint response to the EC call for feedback on the review of the scope and regime for non-EU benchmarks. The response sets out the associations' comments on the EC's proposal, along with potential draft amendments and additional revisions that were considered to support the EC's aims. In the response, the associations welcome the EC's recognition of the problems caused by the current drafting of the Benchmark Regulation (BMR). The associations support the aim of establishing a third-country regime that is sustainable in the long term once the current transitional regime expires, and overall consider that the proposal will result in a more proportionate regime for users and administrators of benchmarks. [NEW]
- **ISDA, FIA Respond to MAS Consultation on Amendments to the Capital Framework for Approved Exchanges and Clearing Houses**. On January 22, ISDA and the FIA jointly responded to the consultation from the Monetary Authority of Singapore (MAS) on proposed amendments to the capital framework for approved exchanges and approved clearing houses. The scope of the response is limited to the capital framework for approved clearing houses. The associations stated that they welcomed the introduction of a separate liquidity requirement and proposed that MAS consider a more conservative minimum threshold of at least 12 months of operating expenses. They also agreed with the proposed amendments that capital components should only include equity instruments and exclude an approved clearing house's skin-in-the-game. For total risk requirement, the response suggests the alignment of the operational risk component with the liquidity risk requirement and the inclusion of some clarifications on the investment risk and general counterparty risk components.
- **ISDA Launches Digital Version of 2002 ISDA Equity Derivatives Definitions**. On January 18, ISDA launched a fully digital edition of the 2002 ISDA Equity Derivatives Definitions on the ISDA MyLibrary platform, enabling new versions to be released more efficiently as products and market practices evolve in the future. Following consultation with buy- and sell-side market participants, ISDA identified support to move the definitions to a digital format, develop new product provisions and streamline certain components over time. Publication of the 2002 ISDA Equity Derivatives Definitions in digital form is a first step and enables further changes to be made in future versions.
- **BCBS-IOSCO Report Sets Out Recommendations for Good Margin Practices in Non-Centrally Cleared Markets**. On January 17, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) published a report on streamlining VM processes and IM responsiveness of margin models in non-centrally cleared markets, which sets out recommendations for market practices intended to enhance market functioning. The report articulates the policy analyses work carried out by the BCBS-IOSCO in two areas discussed in the September 2022 *Review of margining practices*: (i) exploring the need to streamline variation margin processes in non-centrally cleared markets and (ii) investigating the responsiveness of initial margin models in non-centrally cleared markets. The consultative report sets out eight recommendations intended to encourage the widespread implementation of good market practices but does not propose any policy changes to the BCBS-IOSCO frameworks. BCBS and IOSCO stated that the first four recommendations aim to address challenges that could inhibit a seamless exchange of variation margin during a period of stress. The other four highlight practices for market participants to implement initiatives in an effort to ensure the calculation of initial margin is

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consistently adequate for contemporaneous market conditions and proposes that supervisors should monitor whether these developments are sufficient to make this model responsive enough to extreme market shocks.

- **ISDA Launches Sustainability-linked Derivatives Clause Library**. On January 17, ISDA launched a clause library for sustainability-linked derivatives (SLDs), designed to provide standardized drafting options for market participants to use when negotiating SLD transactions with counterparties. SLDs embed a sustainability-linked cashflow in a derivatives structure and use key performance indicators (KPIs) to monitor compliance with environmental, social and governance (ESG) targets, incentivizing parties to meet their sustainability objectives.
- **BCBS, CPMI, and IOSCO Publish Consultative Report on Transparency and Responsiveness of Initial Margin in Centrally Cleared Markets**. On January 16, BCBS, the Bank for International Settlements' Committee on Payments and Market Infrastructures (CPMI) and IOSCO jointly published a consultative report—*Transparency and responsiveness of initial margin in centrally cleared markets*– review and policy proposals—which interested parties are invited to comment on. BCBS, CPMI, and IOSCO stated that the ten policy proposals in the report aim to increase the resilience of the centrally cleared ecosystem by improving participants' understanding of central counterparties (CCPs) initial margin calculations and potential future margin requirements. The proposals cover CCP simulation tools, CCP disclosures, measurement of initial margin responsiveness, governance frameworks and margin model overrides, and clearing member transparency.
- **ISDA and SIFMA Response to US Basel III NPR**. On January 16, ISDA and the Securities Industry and Financial Markets Association (SIFMA) submitted a joint response on the US Basel III 'endgame' notice of proposed rulemaking (NPR). The response focuses on the Fundamental Review of the Trading Book (FRTB), the revised credit valuation adjustment (CVA) framework, the securities financing transactions requirements and elements of the standardized approach to counterparty credit risk rules. In the response, the associations propose a number of calibration changes to ensure the rules are appropriate and risk sensitive and avoid adverse consequences to US capital markets.
- **ISDA and SIFMA Response to G-SIB Surcharge Framework Consultation**. On January 16, ISDA and SIFMA submitted a response to a consultation by the US Federal Reserve on proposed changes to the G-SIB surcharge. The response raises concerns that the revised G-SIB surcharge would lead to inappropriately high capital requirements for banks offering client clearing services, potentially discouraging them from participating in this business and contravening a long-standing policy objective to promote central clearing. Specifically, the response argues that client derivatives transactions cleared under the agency model should not be included in the complexity and interconnectedness categories of the G-SIB surcharge calculation.

The following Gibson Dunn attorneys assisted in preparing this update: Jeffrey Steiner, Adam Lapidus, Marc Aaron Takagaki, Hayden McGovern, and Karin Thrasher. Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Derivatives practice group, or the following practice leaders and authors: Jeffrey L. Steiner, Washington, D.C. (202.887.3632, jsteiner@gibsondunn.com) Michael D. Bopp, Washington, D.C. (202.955.8256, mbopp@gibsondunn.com) Michelle M. Kirschner, London (+44 (0)20 7071.4212, mkirschner@gibsondunn.com) Darius Mehraban, New York (212.351.2428, dmehraban@gibsondunn.com) Jason J. Cabral, New York (212.351.6267, jcabral@gibsondunn.com) Adam Lapidus – New York (+1 212.351.3869, alapidus@gibsondunn.com) Stephanie L. Brooker, Washington, D.C. (202.887.3502, sbrooker@gibsondunn.com) Roscoe Jones Jr., Washington, D.C.

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