



Morgan Lewis

**ADVANCED TOPICS IN
HEDGE FUND PRACTICES
CONFERENCE**

Manager and Investor Perspectives

NEW YORK

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Derivatives Update

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Derivatives Update – LIBOR

USD LIBOR cessation immediately after June 30, 2023:

1

All tenors that have not already ceased will cease

2

The UK's FCA will require LIBOR's administrator, ICE Benchmark Administration Limited, to continue the publication of the one-, three- and six-month US dollar LIBOR settings using an unrepresentative "synthetic" methodology until September 30, 2024

3

Many underlying financial documents have not been adjusted

Derivatives Update – LIBOR

Federal Adjustable Interest Rate (LIBOR) Act will automatically adjust some contracts (but not all).

SEC's Division of Examinations published a Risk Alert regarding observations from examinations to assess preparedness for the cessation of LIBOR. Advisers must prepare.

Derivatives Update – FICC REPO

Cleared Repo is gaining in popularity

Hedge funds can have a combination of bilateral repo and cleared repo

Cleared repo is designed to remove counterparty risk

Documentation for cleared repo is different:

- Requires an agreement with the FICC
- Requires the selection of a sponsoring member as well as a reimbursement agreement with the sponsoring member
- Requires modifications to bilateral repo agreements that may be used with cleared repo

Derivatives Update – CFTC and SEC Debate Index-Based ETF Swaps

Under the framework for swaps established by Dodd-Frank:

- CFTC regulates swaps
- SEC regulates security-based swaps
- CFTC and SEC jointly regulate mixed swaps

Joint Release of SEC and CFTC (August 13, 2012)—“Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; “Security-Based Swap Agreement Recordkeeping”

- CFTC Regulates swaps based on a custom basket of securities constituting a broad-based security index
- SEC Regulates swaps based on a single security or a narrow-based security index (security-based swaps)

Now at issue: swaps based on the share of an exchange-traded fund (ETF) that tracks broad-based indexes of securities (Index-Based ETF Swaps)

- CFTC says that Index-Based ETF Swaps are swaps regulated by the CFTC, or, at a minimum, a mixed swap
- SEC says that Index-Based ETF Swaps are security-based swaps

Derivatives Update – CFTC and SEC Debate Archegos Capital Management Index-Based ETF Swaps

- ***CFTC v. Archegos Capital Management***
 - CFTC alleges that Archegos Fund, in connection with an alleged fraudulent scheme, entered into two kinds of broad-based security index swaps:
 - Index-Based ETF Swaps
 - Swaps based on custom baskets of many different securities
- ***SEC v. Archegos Capital Management***
 - SEC initiated a proceeding against Archegos’s on single-name security swaps
- **Archegos filed motion to dismiss in the CFTC case arguing that the CFTC did not have jurisdiction over the Index-Based ETF Swaps or the swaps based on large custom baskets of securities**
- **SEC filed an amicus brief in the CFTC case in support of Archegos’s motion to dismiss, arguing that as a matter of law, swaps based on the shares of an ETF are security-based swaps subject to sole SEC jurisdiction**

Derivatives Update – CFTC and SEC Debate Index-Based ETF Swaps

• CFTC Arguments

- CFTC has jurisdiction over Index-Based ETF Swaps because they are based on broad-based security indexes
- An index refers to any index or group of securities, including any interest therein or based on the value thereof
 - S&P 500, MSCI Emerging Market Index, and NASDAQ-100 Index, which the SPY, EEM, and QQQ ETFs, respectively, provide exposure to and are designed to track, are broad-based security indexes
 - To track the indices the ETFs hold portfolios of securities that closely match the securities in the indexes, and thus the portfolios of securities are indexes because they are groups of securities and are broad-based
 - Because the definition of index includes not just groups of securities but also any interest therein or based on the value thereof the Index-Based ETFs are broad based indexes because they are interest in and based on the value of the broad-based portfolios of securities held by the ETFs

• SEC Amicus Arguments

- ETF shares are single securities and therefore swaps based on an ETF's shares are security-based swaps
- Inappropriate to look through the shares of an ETF for purposes of assessing CFTC jurisdiction
- The term "based on" is satisfied only when a swap expressly and directly references a broad-based index

Digital Assets in Derivatives and Trading Agreements

SIFMA Gap Analysis

- On January 25, 2023, SIFMA issued some guidance on Addressing Regulatory Gaps in the Digital Asset Ecosystem
- Common Requirements to Extend to Digital Asset-Related Activities

ISDA Definitions

- On January 26, 2023, ISDA published new standard documentation for the trading of digital asset derivatives (the Digital Asset Definitions)
- Digital asset definitions, underlying assets, settlement, disruption events

Digital Assets in Derivatives and Trading Agreements

Netting and Collateral Enforceability:

On January 26, 2023, ISDA published a white paper titled Navigating Bankruptcy in Digital Asset Markets: Netting and Collateral Enforceability

Addresses certain legal issues in the context of bankruptcy proceedings

Closeout netting – netting arrangement should be enforceable in certain major jurisdictions; ISDA netting opinion updates for digital assets

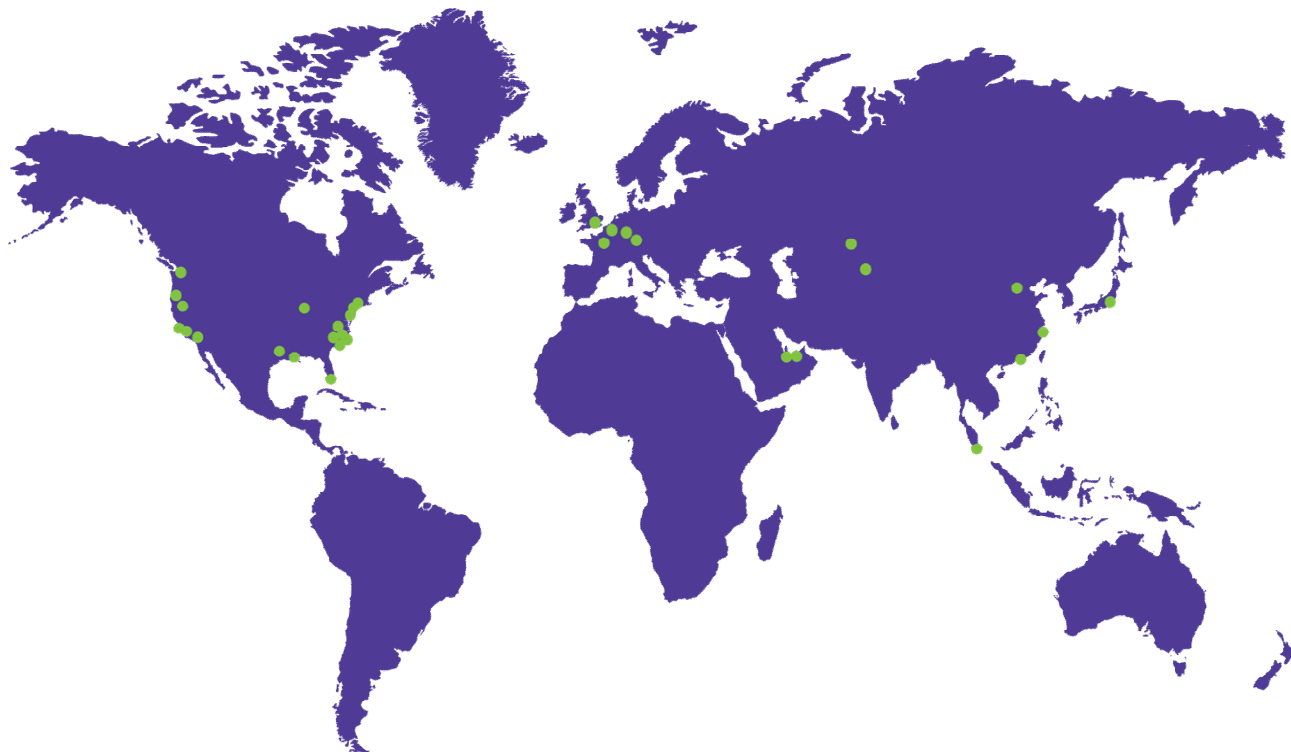
Use of digital assets as collateral – interconnection between technology and law to determine ownership of digital assets; whether transfer of collateral constitutes title transfer/creates security interest; step required to perfect security interest; how to establish control over collateral

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