

Current Issues in Derivatives

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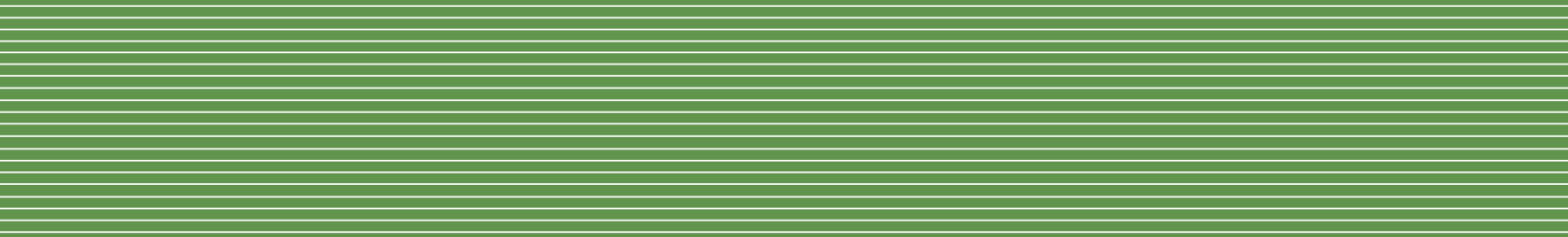
April 22, 2020



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CFTC Regulatory Relief

Presented by Michael Loesch and Jon Ammons



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CFTC Response to Covid-19

- CFTC Chairman Heath Tarbert recently explained the CFTC's 5 key objectives during the Covid-19 crisis:
 1. Increased monitoring of the derivatives markets and their participants
 2. Using the CFTC's regulatory framework to promote orderly and liquid markets
 3. Responding swiftly to changing conditions with practical, targeted relief
 4. Communicating consistently and transparently with all stakeholders
 5. Maintaining the CFTC's commitment to advancing strategic policy goals
- In connection with the third point, CFTC staff have recently issued several rounds of relief to registrants and market participants

Overview of CFTC and NFA's Covid-19-Related Relief

- CFTC issued four rounds of relief related to the Covid-19 pandemic
 - March 17: Relief for FCMs, IBs, swap dealers, RFEDs, floor brokers, and members of SEFs and DCMs
 - March 17 (Round 2): Relief for SEFs and DCMs
 - March 20: Relief for CPOs
 - March 31: Relief for foreign brokers relying on Rule 30.5
- NFA provided its members with relief consistent with certain of these actions
- CFTC extended the comment periods for several rules on April 10

Relief for FCMs, IBs, Swap Dealers, RFEDs, Floor Brokers, and Members of SEFs and DCMs

- CFTC no-action letters provide relief to the following persons from:
 - the requirement to record oral communications related to voice trading and other telephonic communications, and
 - time-stamping requirements when located in remote, socially-distanced locations

Type of Relief	FCMs	IBs*	Swap Dealers	RFEDs	Floor Brokers**	SEF/DCM Members
Recording Oral Communications	X	X	X	X	X	
Time Stamping	X	X	X	X	X	X

- All relief is effective until June 30, 2020
- Relief is conditioned upon registrants establishing a supervisory system reasonably designed to supervise the activities of personnel while acting from a remote location

Relief for FCMs, IBs, Swap Dealers, RFEDs, Floor Brokers, and Members of SEFs and DCMs

- For swap dealers, no-action letter also provides an additional 30 days to file an annual CCO report
- For floor brokers, no-action letter also allows them to engage in trading activities from remote locations (*i.e.*, away from DCMs) without triggering the requirement to register as IBs
- The NFA also provided relief to independent IB members from the timing requirements for filing certified financial reports and semi-annual, quarterly or monthly reports

Relief for CPOs

- CFTC and NFA provided relief to CPOs from the timing requirements for Form CPO-PQR and Form PQR:
 - Timing for Form CPO-PQR (CFTC Form):
 - Extension for **annual filing** from **March 30 to May 15** (for CPOs of Small and Mid-Sized Pools)
 - Extension for **Q1 report** from **May 30 to July 15** (for CPOs of Large Pools)
 - Timing for Form PQR (NFA Form):
 - For all CPOs, time extension for: (1) **Q4 2019 report** from **March 30 to May 15**, and (2) **Q1 2020 report** from **May 30 to July 15**
- CFTC and NFA relief related to Pool Annual Reports:
 - Relief provides an **extra 45 days** for file an **Annual Report** for CPOs of any pool with a report due on or before April 30, 2020

Relief for CPOs

- CFTC and NFA relief related to Periodic Account Statements:
 - Relief provides an **extra 15 days** to distribute any periodic (i.e., monthly or quarterly) **account statements** to pool participants for any reporting periods ending on or before April 30, 2020

Relief for SEFs and DCMs

- CFTC provided relief (until June 30, 2020) from certain audit trail requirements for SEFs and DCMs that cannot comply due to:
 - (1) inability to record voice communications (in the case of SEFs), and
 - (2) displacement of Members from the exchange's premises (in the case of DCMs)
- CFTC granted SEFs an additional 60 days to submit their annual CCO reports and quarterly financial statements

Relief for Foreign Brokers

- CFTC relief allows non-US affiliates of registered FCMs, and which are exempt from IB registration under Rule 30.5, to accept orders from US persons if the US FCM's personnel are unable to handle order flow due to remote working environments
- Relief is subject to a number of conditions, including that:
 - Customers are limited to institutional entities
 - The foreign broker does not handle any customer funds
 - The foreign broker complies with CFTC recordkeeping requirements
 - The relevant FCM files with the NFA an acknowledgment that it will be jointly and severally liable for violations by the foreign broker
 - The foreign broker files a notice with the CFTC's DSIO

COVID-19 and Force Majeure Claims

Presented by Jason Lewis



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Introduction to Force Majeure

- ***Depends first and foremost on the language of the relevant contract***
- Courts will impose gap fillers or interpret ambiguities, but typically construe force majeure clauses strictly
- List of potential force majeure events often dispositive
- Lack of foreseeability may be required
- Certain events may be excluded from force majeure definition
- Clauses typically require that the force majeure prevent or delay performance
- Other obligations if declare an excuse from performance, e.g.:
 - Provide notice within a given time
 - Use a required quantum of efforts to overcome or avoid the force majeure

Case Study: ENI v. Hess

- *Hess Corporation v. ENI Petroleum US, LLC et al.*, 435 N.J. Super. 39 (N.J. Super. Ct. App. Div. 2014)
- ENI sold firm gas to Hess at a liquid trading point; ENI's transportation was curtailed; ENI declared force majeure
- Force majeure clause stated that failure to perform was excused if caused by a force majeure
- Because the transaction was firm and did not designate a particular pipeline, the failure of a single transporter did not excuse seller's failure
 - I.e., ENI could have met its obligations via a different transporter
- Court held that ENI's performance was not excused
- Object lesson: look to the obligations of the parties to determine whether force majeure actually prevented performance

Force Majeure in Derivative Agreements

- The ISDA 2002 Master Agreement (but not the 1992 version) includes a Termination Event for Force Majeure if:
 - After giving effect to any disruption fallback or other remedy
 - By reason of force majeure or an act of state after a Transaction is entered into either:
 - Making or receipt of payments or deliveries is prevented or compliance with a material provision of the Agreement is prevented, or it becomes impossible or impracticable to so perform, receive or comply; or
 - A party (or its Credit Support Provider) is prevented from making or receiving payment or delivery under a Credit Support Document, or it becomes impossible or impracticable to do so
 - If the force majeure or act of state is beyond the control of the relevant Office
 - Must use all reasonable efforts to overcome the event
- Generally, difficult for parties to establish the above elements
- Most relevant in transactions related to emerging markets

Force Majeure in Physical Power Agreements

- ISDA Power Annex defines “Force Majeure” as follows (definition in EEI Master Power Purchase and Sale Agreement is virtually identical):

“Force Majeure” means an event or circumstance which prevents the Claiming Party from performing its obligations under one or more Power Transactions, which event or circumstance was not anticipated as of the date the Power Transaction was agreed to, which is not within the reasonable control of, or the result of the negligence of, the Claiming Party, and which, by the exercise of due diligence, the Claiming Party is unable to overcome or avoid or cause to be avoided. Force Majeure shall not be based on (i) the loss of Buyer’s markets; (ii) Buyer’s inability economically to use or resell the Product purchased hereunder; (iii) the loss or failure of Seller’s supply; or (iv) Seller’s ability to sell the Product at a price greater than the Contract Price . . . ; provided, however, that existence of the foregoing factors shall not be sufficient to conclusively or presumptively prove the existence of a Force Majeure absent a showing of other facts and circumstances which in the aggregate with such factors establish that a Force Majeure as defined in the first sentence hereof has occurred

- Above does not include a list of events that constitute Force Majeure

Force Majeure in Physical Power Agreements (cont.)

- Force Majeure provision in ISDA Power Annex (virtually identical in EEI Master Power Purchase and Sale Agreement):

To the extent either party is prevented by Force Majeure from carrying out, in whole or part, its obligations under any Power Transaction and such party (the “Claiming Party”) gives notice and details of the Force Majeure to the other party (the “non- Claiming Party”) as soon as practicable, then, unless the terms of the Product specify otherwise, the Claiming Party shall be excused from the performance of its obligations with respect to such Power Transaction (other than the obligation to make payments then due or becoming due with respect to performance prior to the Force Majeure). The Claiming Party shall remedy the Force Majeure with all reasonable dispatch. The non-Claiming Party shall not be required to perform or resume performance of its obligations to the Claiming Party corresponding to the obligations of the Claiming Party excused by Force Majeure. If the pre-printed form portion of this Agreement is the 2002 ISDA Master Agreement form, Section 5(b)(ii) of this Agreement shall not apply to any Power Transaction.

- Force Majeure Termination Event is “turned off” under Power Annex
- Bespoke PPAs vary, but typically contain similar clauses

COVID-19 and Power Hedges – Construction Phase

- In agreements for projects under development, force majeure may provide an excuse for delay in achieving project milestones, but such excuses or extensions should be stated expressly in the hedge documents
 - Achievement of project milestones typically not an obligation, so failure to do so may not be excused by standard force majeure provisions
 - In some cases, if a force majeure prevents achievement of a project milestone, then the milestone will be extended
 - But some agreements, like PPAs or virtual PPAs, are more likely than others to permit such extensions
 - Even in such cases, however, the force majeure must prevent achievement of the milestone; so the COVID-19 outbreak alone may not justify an extension
 - Some bank hedges permit an extension of the commercial operation date milestone in exchange for a collateral substitution

COVID-19 and Power Hedges – Operational Phase

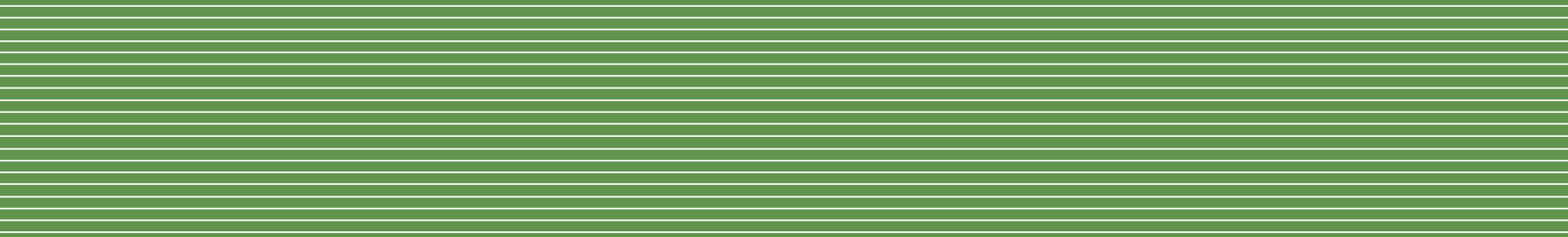
- During operational phase, performance of the obligation to deliver and sell power may be excused as a result of the COVID-19 outbreak, but will depend on a close analysis of the contract and whether the outbreak prevented performance
- Consider whether such an excuse may exist under the following transaction structures:
 - Fixed-for-float swap
 - Power purchase agreement
 - Firm sale of power
 - Unit contingent sale of power
 - Bank hedge
 - Virtual PPA
 - Proxy revenue swap

Parting Thoughts

- Do not assume that performance will be excused simply because of the COVID-19 outbreak
- ***Read the applicable contract closely***
 - Consider whether the event is specifically mentioned, or whether it is similar to listed events
 - Consider whether the event actually prevented performance, or whether the party was obligated to perform by alternate means
 - Be sure to comply with obligations to provide notice within a given time, or to attempt to mitigate, avoid or overcome the force majeure as required by the contract
- In general, excuses from performance may be challenging to establish under long-term power hedges

Impact of COVID-19 on LIBOR Transition

Presented by Aaron Levy



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Overview

- Impact of Covid-19 on December 31, 2021 and interim deadlines
 - March 25: FCA and Bank of England Statement
 - Effect on “Interim Transition Milestones” in loan and derivatives markets
- Potential issues with fallbacks and related challenges
 - Concerns regarding ‘Amendment Approach’ (for loans)
 - Concerns regarding SOFR:
 - Fundamental differences between LIBOR and SOFR → potential basis and changes in risk profile
 - Impact of ‘static’ spread adjustments
 - Robustness of SOFR:
 - Behavior during periods of market stress (SOFR spikes)
 - Fed interventions

Impact on Deadlines

- March 25 Statement of FCA and Bank of England:
 - “The central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and should remain the target date for all firms to meet.”
 - “There has, however, been an impact on the timing of some aspects of the transition programmes of many firms. Particularly in segments of the UK market that have made less progress in transition and therefore are more reliant on LIBOR, such as the loan market, it is likely to affect some of the **interim transition milestones**.”
 - E.g., interim deadlines for switching from Sterling LIBOR to SONIA for loans and interest rate swaps
- Legislative delays (e.g., NY legislature’s consideration of ARRC proposal)
- Delays to industry consultations (ISDA, ARRC)
- LIBOR panel banks submissions
 - Market-led change
 - Further progress builds momentum toward transition

Concerns with ‘Amendment Approach’

- Background
 - Amendment: provides a mechanism for parties to negotiate a replacement benchmark rate by agreeing to amend the credit facility in the future (upon a trigger event)
 - Hardwired: automatically implements replacement rate upon trigger event based on application of waterfall (no need for future amendment)
- Amendment Approach Pros and Cons:
 - Pro: Flexibility (as term SOFR rates and credit spread methodologies continue to develop)
 - Cons:
 - Less upfront certainty
 - Practical ability to amend many loan agreements during periods of market disruption
 - For borrowers: Prime base rate fallback (if lenders object to chosen replacement)

Concerns with SOFR (SOFR vs. LIBOR)

- SOFR addresses various issues with LIBOR since SOFR is rooted in hundreds of billions of dollars of actual transactions occurring in overnight repo market (rather than panel bank submissions):
 - Underlying market illiquidity
 - Lack of transparency
 - Potential for manipulation
- However, SOFR differs from LIBOR in several ways that may pose issues:
 - LIBOR is forward-looking, while SOFR (as a collection of daily rates) is currently backward-looking (note: efforts to create forward-looking term SOFR rates are ongoing).
 - As SOFR is based on overnight repos collateralized by Treasuries, it does not adequately reflect bank's cost of funds/creditworthiness
 - Fed interventions in repo markets may have exposed blind spots in SOFR's behavior
 - Volatility → Potential spikes in SOFR and LIBOR-SOFR spread
 - Static spread (five-year historical mean/median approach)

Electronic Execution of Documents by Legal Entities

Presented by Michael O'Brien



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Power, Capacity, Authority – Jurisdiction of Organization of Entity

- Generally Same Effect and Legal Analysis as “Wet-Ink” Signatures
- E.g., DE LLC Act Section 18-113 – For purposes of determining whether a document is signed and delivered in accordance with the Act and the LLC Agreement: Electronic transmission is equivalent of a written document; signature includes electronic signature; and delivery occurs when electronic transmission enters designated (by agreement or context) information processing system in form capable of being processed and can be retrieved
- Trap – Organizational Documents can restrict means of documenting an act or transaction or of signing or delivering IF EXPRESS

Power, Capacity, Authority – Jurisdiction of Organization of Entity (cont.)

- Enforceability – Governing Law of Contract
 - E.g., NY Electronic Signature and Record Act - NY State Tech L Section 301, et. seq. – Electronic signature has same validity and effect as signature affixed by hand; electronic record has same force and effect as record not produced by electronic means
 - Federal – Electronic Signatures in Global and National Commerce Act 15 USC 96 – Applies to transactions in or affecting interstate or foreign commerce – Contract not denied legal effect, validity or enforceability because it is in electronic form or electronic signature or record used in its formation
- Admissibility
 - Electronic record or signature may be admitted subject to compliance with other rules of evidence ESRA section 306, FRE 902(13)

Power, Capacity, Authority – Jurisdiction of Organization of Entity (cont.)

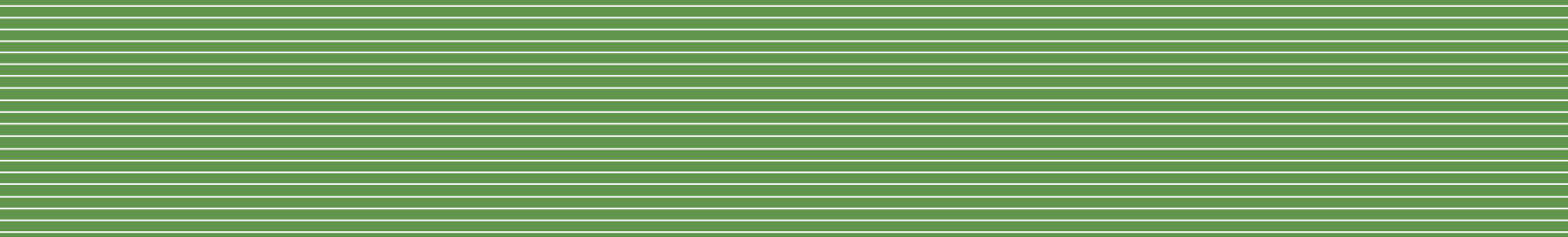
- Record-keeping
 - Dodd Frank requirements can be satisfied with electronic records
- Others
 - NY UCC Article 9 electronic records equivalent to wet-ink documents; NY Statute of Frauds for QFCs, such as swaps, requirement for a writing can be satisfied by electronically executed contracts

Cautions / Best Practices

- Amendments, modifications governed by the e-formed contract – E.g. section 12 of ISDA Master – Notices under Section 5/6 may not be sent by facsimile or e-messaging
- Add statement of intent to be bound by e-creation
- Above generally not applicable to contracts of an individual, personal matters such as estate or family law matters and to documents conveying title;
- Enforceability does not mean will be accepted for filing – e.g. SEC, FAA requirements for filing

CFTC Position Limits Proposals

Presented by Michael Loesch and Jon Ammons



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Position Limits Overview

- “Speculative” position limits are caps imposed on each trader’s positions in a given futures contract during the end of trading for a given delivery month (*i.e.*, the “spot month”)
 - Limits apply on a net long / net short basis
 - Apply on both an intra-day and inter-day basis
- Intended to prevent excessive speculation and the potential for manipulation, as well as unnatural price fluctuations

Current Position Limits Regime

- CFTC imposes Federal position limits on futures and options on 9 agricultural commodities
 - Spot month limits
 - Single month limits
 - All months combined limits
- Futures exchanges set limits on the same futures and options contracts, as well as most other listed contracts
 - Generally only impose spot month limits, and “accountability levels” for positions outside of the spot month
- Certain exemptions from position limits exist:
 - Bona fide hedging exemption
 - Traders relying on a bona fide hedge exemption for any of the agricultural contracts subject to CFTC limits must file a Form 204 or 304 demonstrating the physical positions being hedged
 - Spread or arbitrage exemption
 - Risk management exemption

CFTC Proposed Rule – Overview

- Would expand Federal position limits to all “**Referenced Contracts**”:
 - 25 core futures and options contracts in (1) agricultural, (2) metals and (3) energy commodities (“**Core Referenced Futures Contracts**”, or “**CRFCs**”)
 - Cash-settled futures and option contracts that are directly or indirectly linked to the price of a CRFC, or the same commodity for delivery at the same location as a CRFC
 - Swaps that are “economically equivalent” to another Referenced Contract
 - Must have identical “material” contractual specifications, terms and conditions
 - A swap would not be deemed to have identical material terms if its settlement type (e.g., cash-versus physically settled) differed from any relevant Referenced Contracts
 - Therefore, a cash-settled swap could only be deemed economically equivalent to a cash-settled Referenced Contract – *narrower definition than in prior proposals*

CFTC Proposed Rule – Overview (cont.)

- Proposed rule would impose spot month position limits on all Referenced Contracts, and non-spot month limits only for the legacy agricultural contracts
- No difference in limits for physically-settled and cash-settled contracts (other than the conditional limit for cash-settled natural gas)
- The term “Referenced Contract” excludes location basis contracts, commodity index contracts, swap guarantees, and trade options
- Proposed rule would delay imposition of DCM and SEF-imposed position limits for swaps
- Proposed rule would eliminate existing Forms 204 and 304, and did not re-propose certain other forms (504, 604 and 704)

Netting Limitations

- Proposed rule includes separate limits for physical and cash-settled futures, so cash-settled and physically-settled Referenced Contracts could not be netted against one another (for spot month limits)
- Because cash-settled swaps are deemed only “economically equivalent” to cash-settled Referenced Contracts, such swaps cannot be netted against physical delivery futures contracts
 - But, this reduces the scope of swaps subject to position limits

Bona Fide Hedge Exemption – Enumerated Hedges

- Proposal includes a general definition of a *bona fide* hedge, and a list of **enumerated** *bona fide* hedges that would meet this definition
 - The proposed rule would expand the list of enumerated hedges compared to prior position limits rules and proposals – including anticipated merchandising
 - Market participants need not apply to the CFTC for enumerated hedges, but must request an exemption from the relevant exchange

Bona Fide Hedge Exemption – Non-Enumerated Hedges

- Positions that do not qualify as enumerated hedges may still qualify as **non-enumerated** *bona fide* hedges
 - For non-enumerated hedges, market participants must either apply to: (1) the CFTC and the relevant exchange, or (2) the relevant exchange
 - If applying directly to the exchange, the CFTC (not merely CFTC staff) may stay or reject the exchange determination within 10 business days (or 2 business days for sudden and unforeseen circumstances)
 - This would likely delay the current process for relying on hedge exemptions several days

Enumerated Hedges

Type of Enumerated Hedge	Comments
Hedges of unsold anticipated production	<ul style="list-style-type: none">- Existing enumerated exemption- Removes limitation that only allowed hedging of 12 months' production
Hedges of offsetting unfixed price cash commodity sales and purchases	<ul style="list-style-type: none">- Existing enumerated exemption- Expanded to allow hedges of purchases and sales in the same calendar month
Hedges of anticipated mineral royalties	<ul style="list-style-type: none">- New proposed enumerated exemption- Permits an owner of rights to a future royalty to lock in the price of anticipated mineral production- Short positions only
Hedges of anticipated services	<ul style="list-style-type: none">- New proposed enumerated exemption- Permits hedging of the change in value of payments due or expected under an executed services contract
Cross-commodity hedges	<ul style="list-style-type: none">- Existing enumerated exemption- Commodities must be "substantially related" (<i>i.e.</i>, have a reasonable commercial relationship)

Enumerated Hedges

Type of Enumerated Hedge	Comments
Hedges of inventory and cash commodity fixed-price purchase contracts	<ul style="list-style-type: none">- Existing enumerated exemption- Inventory or fixed-price purchase contract must be on hand- Short positions only
Hedges of cash commodity fixed-price sales contracts	<ul style="list-style-type: none">- Existing enumerated exemption- Permits hedging of spot or forward fixed price sales- Long positions only
Hedges by agents	<ul style="list-style-type: none">- New enumerated hedge (previously was an example of a non-enumerated hedge)- Allows an agent trading physical for a client to also hedge those positions
Offsets of commodity trade options	<ul style="list-style-type: none">- New enumerated exemption- Deems commodity trade options to be cash commodity fixed price purchase or sales contracts
Hedges of unfilled anticipated requirements	<ul style="list-style-type: none">- Existing enumerated hedge- Removes limitation that only allowed hedging of 12 months' requirements
Hedges of anticipated merchandising	See next slide

Hedges of Anticipated Merchandising

- New and much-requested enumerated hedge exemption
- Permits merchants to establish long or short positions to hedge against changes in value of a commodity that they anticipate purchasing or selling in the future
- Conditions:
 - Derivatives position must not exceed 12 months' purchase or sale requirements of the commodity that will be merchandised
 - Merchant must be in the business of purchasing and selling the commodity, and must be able to demonstrate that it has historically done so

Pass-Through Swaps

- Pass-through swaps and offsets of such swaps would qualify as *bona fide* hedging positions
- Pass-through swaps are those: (1) entered into opposite a counterparty using the swap as a *bona fide* hedge, and (2) where the risk from that swap is laid off using offsetting Referenced Contracts in the same physical commodity
- Liquidity providers should consider including representations in transaction documents indicating that the original swap is entered into for *bona fide* hedging purposes

Spread Exemption

- The following spread positions would be exempt from position limits:
 - Calendar spreads
 - Inter-commodity spreads
 - Quality differential spreads
 - Processing spreads (e.g., energy “crack” or soybean “crush” spreads)
 - Product or by-product differential spreads
 - Futures-option spreads
- No application to CFTC is needed to rely on spread exemptions listed above, but market participants must apply to relevant exchange
- If a spread strategy is not included in the enumerated list, a market participant must apply to the CFTC for an exemption

Risk Management Exemption - Eliminated

- The proposal would eliminate the “risk management exemption,” which is primarily relied upon by liquidity providers
 - Currently, this exemption allows liquidity providers to offer instruments such as commodity index swaps to customers, and hedge that exposure through futures contracts
- If the risk management exemption is eliminated, it would curtail the flexibility dealers have in hedging these instruments, and may limit their willingness to offer such contracts
- CFTC states that the: (1) increased non-spot month limits for agricultural contracts, (2) absence of non-spot month limits for other contracts, and (3) existence of the pass-through swap exemption, will mitigate the impact
 - However, the pass-through swap exemption only applies when the dealer’s counterparty is entering into the swap for *bona fide* hedging purposes

Necessity Finding

- The Proposed Rule interprets the statutory language providing for position limits to require the CFTC to make a necessity finding before establishing position limits on any new contracts
- The Proposed Rule includes a preliminary determination that Federal position limits are necessary for the 25 CRFCs and any associated Referenced Contracts, but not any other futures or swap contracts
 - No significant discussion as to why position limits are “necessary” for cash-settled contracts
- Due to the proposed necessity finding requirement, the CFTC would need to find that it is necessary to expand the list of CRFCs before doing so

Comment Period

- Comments were originally due April 29,2020
- Comment period was extended to May 15, 2020 due to the COVID-19 pandemic

Questions?



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