

Current Issues in Derivatives

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Resolution Stay Protocol and Compliance

Jon Ammons and Jason Lewis

- Summary of Restrictions on QFCs of GSIBs
- Choosing a Compliance Option
- Spotlight on Bilateral Compliance Options
- Entering into New QFCs

Overview and Scope

- Purpose: To address concerns about global systemically important banks (“GSIBs”) being “too-big-to-fail,” new laws and regulations enable Prudential Regulators to orderly resolve failing GSIBs by limiting counterparties’ default rights and transfer restrictions regarding Qualified Financial Contracts (“QFCs”)
- Rules apply to “Covered Entities”
 - Covered Entities include:
 - US entities identified as GSIBs together with their subsidiaries
 - US operations of non-US entities identified as a GSIBs
 - Note some excluded entities – e.g., merchant banking subsidiaries
 - Also note impact on those not in scope – i.e., end users
- QFC definition is broad: ISDAs, repos, securities lending, MSFTAs, among others
- QFCs with Covered Entities entered after Jan. 1, 2019 (and, upon such entry, all existing QFCs between parties) may need to be remediated

Primary Regulatory Requirements

- “Stay and Transfer” – If counterparty is non-US or QFC is governed by non-US law, counterparties must acknowledge authority of FDIC to:
 - Impose a temporary stay (up to 48 hours) on default rights, and
 - Transfer QFC to a third party or bridge institution
- “No Cross-Default” – Counterparties must agree to not:
 - Exercise any cross-default (as long as direct counterparty continues to perform), or
 - Restrict the transfer of any parent or affiliate-provided credit enhancement

Compliance

- Compliance deadlines
 - January 1, 2019 – counterparty is also a Covered Entity
 - July 1, 2019 – counterparty is not a Covered Entity but is a “financial counterparty”
 - January 1, 2020 – all other counterparties
- Options to achieve compliance
 - ISDA 2015 Universal Stay Protocol
 - ISDA 2018 U.S. Resolution Stay Protocol
 - ISDA form of bilateral contract
 - Other approved methods?

Choosing a Compliance Option

- ISDA 2015 Universal Stay Protocol
 - Still viable but may contain provisions that are not relevant to most counterparties
- ISDA 2018 Resolution Stay Protocol
 - May be most efficient for some counterparties
 - Rules explicitly grant an additional “creditor protection” to parties that adhere to this protocol (i.e., administrative preference)
 - But adherence is “universal”: automatically amends all QFCs with all GSIBs that have adhered
 - Therefore, some counterparties may wish to adhere with some GSIBs rather than others and with respect to some QFCs only
- Bilateral contracts
 - Rules permit parties to amend relevant QFCs by bilateral contract
 - But, give up the creditor protection described above

Bilateral Compliance Options

- ISDA bilateral contract
 - Four versions (group, single counterparty, group + non-US GSIB, single counterparty + non-US GSIB)
 - Amends QFCs of the GSIB and the bilateral counterparty (or group)
 - Requires representations regarding no adverse effect on Credit Enhancements and no consents required, includes agreement to obtain consents
 - QFC not amended if the “no consent” representation is breached
- New forms of IECA bilateral agreement
 - Four versions, based on ISDA bilateral forms
 - Adds commentary, makes two principal changes to ISDA forms:
 - Parties can specify particular QFCs to be amended in optional schedule
 - If amendment would adversely effect a Credit Enhancement, QFC is not amended
- Bespoke agreements?

Entering into New QFCs

- Resolution Stay Protocols only amend QFCs entered into prior to date of adherence
- For new QFCs, GSIBs have developed language that incorporates the terms of the relevant Resolution Stay Protocol
 - If counterparty has not yet adhered, GSIBs are generally requiring counterparties to incorporate by reference the substantive sections of the ISDA 2018 Resolution Stay Protocol, even if compliance deadline has not occurred yet
- All such provisions will constitute bilateral contracts that do not qualify for the additional creditor protections that apply if adhering to protocol
- Provisions generally contain the following:
 - Incorporation by reference of ISDA 2018 Resolution Stay Protocol
 - The ISDA in question deemed a “Covered Agreement” and the applicable dealer deemed a “Covered Entity”
 - Effect of future adherence to protocol

Power Hedges

Michael O'Brien and Jason Lewis

- Uptick in Power Hedging Activity
- Trends – On Balance Sheet; RECs; Solar
- Anatomy of Physically Settled Renewable Hedge

Context

- Significant Uptick in Power Hedging Activity for:
 - Project Development, particularly renewables
 - Balance Sheet Hedging (e.g., Utilities)
 - Energy Marketing

Financially Settled vs. Physically Settled

- **Financially Settled** – e.g., Fixed v. Floating swap on pre-agreed notional quantities; issues include:
 - Basis risk between Floating Price (typically at Hub) and Nodal Price
 - Regulated as a swap for Dodd-Frank purposes
 - Documented under ISDA
- **Physically Settled** – e.g., Seller delivers pre-agreed quantity of power against payment of Fixed Price; delivery typically achieved by scheduling delivery and receipt with market operator; issues include:
 - Excuses for failure to deliver or receive (e.g. Force Majeure)
 - Unexcused failures to delivery or receive (cost to cover, right to suspend performance)
 - Responsibilities to market operator
 - Physicals are not swaps for Dodd-Frank purposes (note CFTC relief for organized markets), but are regulated by FERC/PUCT
 - Documented under ISDAs or EEs

Trends

- **On Balance Sheet Transactions** – Developers more willing to backstop hedges on balance sheet (particularly those with Utility Company parents) v. traditional limited recourse project financing
 - Advantage: reduces scope and cost of collateral required
- **RECs (and other environmental attributes)** – Credit, allowance or indicia of generation of particular quantity of power from a certified renewable energy source
 - Title transferred through accounts at a regulated registry
 - Purchasers (e.g., Utilities) typically buy RECs as one way to satisfy RPSs
 - Many markets separately price
 - Force Majeure excuses to delivery
 - When bundled with power purchases need mechanism to separately value
 - Due to physical settlement (registry transfers) RECs are not swaps for Dodd Frank purposes
 - Range of documentation possibilities including EEI (i.e., EEI REC Annex) and ISDA (common bespoke addition to ISDA Schedule)

Trends *(cont.)*

- Hedges for Solar Projects
 - Production Tax Credit for wind v. Investment Tax Credit for solar
 - Implications of recapture risk for solar
 - Hedge Providers beginning to get comfortable with notion of five year forbearance to avoid recapture risk (letters of credit, upstream pledges)

Anatomy of Typical Physical Power Hedge Renewable

- **Seller:** Project Company/Generator
- **Buyer:** Hedge Provider
- **Trade Date:** T
- **Effective Date:** T + 9 months
- **Termination Date:** Effective Date plus 12 years
- **Contract Price:** \$XY per month
- **Quantities:** Pre-Agreed Quantities – By Hour and By Month (e.g. P99 generation)
- **Delivery Point:** Hub (e.g., ERCOT North)
- **Scheduling:** Seller schedules delivery, and Buyer schedules receipt, of agreed quantities with market operator at Delivery Point
- **Payments:** Buyer pays Contract Price for quantities either monthly or daily
- **Tracking Account:** Monthly True-Up based on variance (negative or positive) between actual revenues and expected revenues; functions as working capital facility; accrues interest; builds up to limit; payable at termination
- **Credit Support:** Pre-Effective Date – e.g., Letter of Credit; Post-Effective Date – First Lien
- **Required Milestones:** Deadline for COD; Minimum Capacity at COD

CFTC Update

Michael Loesch and Jon Ammons

- Regulatory Initiatives (pending and anticipated)
- Other Areas of CFTC Attention

CFTC Regulatory Initiatives (pending and anticipated)



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Proposed Rulemakings – Pending

- Swap Execution Facilities
 - Elimination of “Made Available to Trade” Requirement
 - Currently, for a swap to become subject to mandatory trading, two requirements must be met:
 - The CFTC must determine that the swap is subject to mandatory clearing, and
 - A SEF (or DCM) must issue a made-available-to-trade (MAT) determination
 - The proposed rules would eliminate the second prong – as a result, any swap subject to mandatory clearing would be subject to mandatory trading, if listed by at least one SEF
 - Changes to Methods of Execution
 - The existing rules prescribe narrow methods of execution for Required Transactions
 - Required Transactions must be executed on an Order Book or via RFQ-to-3
 - The proposed rules would eliminate the requirement for SEFs to maintain an Order Book, and the requirement that Required Transactions be executed by an Order Book or RFQ-to-3

Proposed Rulemakings – Pending

- Swap Data Repositories and Reporting
 - Open Swaps Reports
 - Proposed rule would require SDRs to periodically send to each reporting counterparty an “open swaps report” showing every data field for every open swap
 - Weekly for SDs and DCOs
 - Monthly for all other reporting counterparties
 - Data Verification
 - Reporting counterparties would be required to verify to the SDR whether data in the report is (1) complete and accurate data or (2) has one or more discrepancies
 - Data Corrections
 - Errors or omissions would be required to be corrected as soon as technologically practicable after discovery (but within three business days)
 - Reporting counterparty must “immediately” notify the CFTC’s DMO if data cannot be corrected within 3 days; must include an initial assessment of the scope of the errors/omissions and an initial remediation plan

Proposed Rulemakings – Pending

- Derivatives Clearing Organizations
 - Outgrowth of Project KISS
 - Codification of Best Practices
 - New requirements regarding governance procedure – generally not prescriptive
 - New conflicts of interest standards and requirements regarding governing boards
 - Requirement to have a default committee, and to include clearing members in default management tests
 - Other Issues
 - Clarifies that a DCO's initial margin calculations must address concentration risk
 - New procedures for filing proposals regarding cross-margining programs involving multiple DCOs
 - New requirement for DCOs to submit certain rule changes for approval (rather than self-certification)
 - Including transfers of open interest; cross-margining; and commingling of futures, options and swaps in a futures account

Proposed Rulemakings – Anticipated

- Speculative Position Limits
 - Proposal currently expected to be released in June
 - All Commissioners committed to Congress during their confirmation hearings that they would work to finalize new rules
 - New CFTC limits likely to be imposed on 25 physical commodity futures contracts (including energy and metals), and economically equivalent swaps, with expanded reporting requirements as well
 - Proposal likely to broaden bona fide hedging exemption, and give Exchanges greater authority to grant them, as compared to prior proposals

Proposed Rulemakings – Anticipated

- Cross-Border Swap Activities: Chairman wants to replace CFTC’s existing cross-border guidance with rules that—
 - Distinguish between swap reforms that are designed to mitigate cross-border systemic risk (e.g., clearing, capital), as opposed to reforms that address particular market and trading practices and thus are suitable to local requirements (e.g., SEF execution requirements)
 - Pursue multilateralism for swap reforms designed to mitigate systemic risk
 - Defer to comparable swap reforms in non-US markets by adopting a flexible, outcomes-based approach to substituted compliance
 - Revisit swap dealer *de minimis* calculations – what counts and for whom?
 - Encourage adoption of comparable swap regulation in non-US markets that have not yet adopted swap reforms for significant swaps trading activity

Proposed Rulemakings – Anticipated

- Swap Data Reporting
 - DMO staff is working on rule amendments that, among other things, are expected to include—
 - Aligning data standards across SDRs to make data more usable
 - Better defined and standardized reporting fields
 - Eliminating the embargo rule, at least to allow work-ups

Other Areas of CFTC Attention



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Additional CFTC Priorities

- Virtual Currencies: Focus is on—
 - Improved consumer education, and staff competency
 - Increased interagency cooperation
 - Full exercise of existing authority
 - New surveillance tools and strong enforcement
 - Heightened review of Exchanges' virtual currency futures self-certifications
- Brexit
 - Ensuring that trading platforms and clearinghouses can continue to function post-Brexit
 - Equivalence – the CFTC's position:
 - US and EU reached an agreement regarding equivalence in 2016 – no renegotiation;
 - US clearinghouses to be treated by EU the same as they are now: and
 - US and EU to pledge support for deference in regulation and supervision of each other's clearinghouses

Additional CFTC Priorities

- Margin
 - Working with Prudential Regulators to address issues with supplementary leverage ratio (SLR) – *i.e.*, treating customer margin as risk creating rather than risk reducing
 - DSIO may be considering relief for Phase 5 initial margin requirements
- Exemptions
 - DCR is considering certain exempt DCO applications (mostly from Asia)
 - DCR is considering proposals regarding alternative methods to access clearing (e.g., non-FCM clearing members)

Additional CFTC Priorities

- Cyber Security
 - Improved oversight of cyber defense capabilities of regulated markets and intermediaries (and CFTC's own cyber security)
- Inter-Agency Cooperation
 - Harmonization of rules with SEC
 - Working with Federal Reserve to share analysis, information, and supervisory experiences re systemically important clearinghouses