

Current Issues in Derivatives

Presented by:

Michael O'Brien

Chair, Derivatives and
Structured Products, Chicago

Michael Loesch

Partner, Washington, D.C.

Jon Ammons

Of Counsel, Washington, D.C.

Aaron Levy

Of Counsel, New York

Jason Lewis

Of Counsel, New York

July 22, 2020



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& STRAWN
LLP

CFTC Civil Monetary Penalty Guidance

Presented by Michael Loesch



Focus on Transparency

- Since taking office in July 2019, **CFTC Chairman Tarbert** has emphasized the importance of transparency
- Adopted four **CFTC core values** – including Clarity – “*Providing transparency to market participants about our rules and processes*”
- Outlined **transparency initiatives** in December 2019:
 - Regulation – More open meetings, more formal rulemaking instead of no-action letters, publication of requests for no-action and interpretive guidance
 - Enforcement – Publish updated enforcement manual, fewer limitations on ability to discuss settlements



[W]e must be transparent in how we enforce the law. One goal of our enforcement program is to change behavior in a positive way by deterring misconduct before it happens. **Deterrence requires clarity about how our laws work.**



CFTC Chairman Heath Tarbert
December 10, 2020

Enforcement Division Penalty Guidance

- In May 2020, the CFTC’s Division of Enforcement issued **new civil monetary penalty guidance**
 - outlines various **factors the Division staff will consider** in recommending a civil monetary penalty to the Commission in an enforcement action
- The Division guidance reflects the Commission’s recent commitment to increased transparency
 - **provides market participants with more information** regarding the Enforcement Division’s **decision-making process and the criteria** for imposing civil monetary penalties in enforcement proceedings



Division of
Enforcement

COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5000
Facsimile: (202) 418-5521
www.cftc.gov

MEMORANDUM

TO: Division of Enforcement Staff
FROM: James M. McDonald
Director, Division of Enforcement
DATE: May 20, 2020
SUBJECT: Civil Monetary Penalty Guidance

This memorandum summarizes various factors that Commodity Futures Trading Commission (“CFTC” or “Commission”) Division of Enforcement (“Division”) staff will consider in recommending an appropriate civil monetary penalty to the Commission in an enforcement action, whether administrative or injunctive. This guidance will be set forth in the Enforcement Manual,¹ and will be binding on all Division staff.

Recently, the Commission for the first time articulated a set of core agency values, namely: Commitment, Forward-thinking, Teamwork, and Clarity.² In particular, this Division guidance advances the core value of clarity, providing market participants with greater transparency as to Division staff’s decision-making criteria regarding civil monetary penalties. This guidance will facilitate the Division’s efforts to be tough on those who break the rules while striving for fair and consistent outcomes in doing so. As Chairman Tarbert has stated, “[W]e must be transparent in how we enforce the law. One goal of our enforcement program is to change behavior in a positive way by deterring misconduct before it happens. Deterrence requires clarity about how our laws work.”³

The factors below generally reflect the existing practice within the Division, which has been refined over time as a result of changes to relevant legal authorities and precedents, as well as lessons learned from the Commission’s enforcement actions.

The Commission, through the Division, acts to protect the public and preserve market integrity by detecting, investigating, and prosecuting violations of the Commodity Exchange Act (“Act”) and Commission Regulations (“Regulations”). In furtherance of that mandate, the Commission may require civil monetary penalties against individuals and companies in

CFTC Penalty Authority and Background

- The **Commodity Exchange Act (CEA)** authorizes **civil monetary penalties** for each violation of the Act and CFTC Regulations (See, e.g., Section 6(c)(10))
 - Sets the maximum penalty per violation
 - Penalties may be determined on a per violation basis or up to triple monetary gain (whichever is greater)
- The CEA requires that penalties be assessed in relation to **the gravity of the violation** (See, e.g., Section 6(e)(1))
- **In 1994, the Commission published guidelines** listing factors that influence its assessment of civil monetary penalties (these remain in place)
- The **2020 Enforcement Division Guidance** does not supersede the 1994 guidelines – it is informed by and consistent with the 1994 guidelines

Inflation Adjusted Civil Monetary Penalties Administered by the Commodity Futures Trading Commission (as of January 13, 2020)

(1) For Non-Manipulation or Non-Attempted Manipulation Violations

U.S. Code Citation	Civil Monetary Penalty Description	Date of Violation and Corresponding Penalty			
		10/23/2004 through 10/22/2008	10/23/2008 through 10/22/2012	10/23/2012 through 11/01/2015	11/02/2015 to Present
Civil Monetary Penalty Imposed By The Commission In An Administrative Action					
7 U.S.C. 9 (Section 6(c) of the Commodity Exchange Act)	For any person other than a registered entity*	\$130,000	\$130,000	\$140,000	\$168,142
7 U.S.C. 13a (Section 6b of the Commodity Exchange Act)	For a registered entity* or any of its directors, officers or employees	\$625,000	\$675,000	\$700,000	\$926,213
Civil Monetary Penalty Imposed By A Federal District Court In A Civil Injunctive Action					
7 U.S.C. 13a-1 (Section 6c of the Commodity Exchange Act)	Any Person	\$130,000	\$140,000	\$140,000	\$185,242
*The term "Registered Entity" is defined in 7 U.S.C. 1a (Section 1a of the Commodity Exchange Act).					

(2) For Manipulation or Attempted Manipulation Violations

U.S. Code Citation	Civil Monetary Penalty Description	Date of Violation and Corresponding Penalty			
		10/23/2004 through 05/21/2008	05/22/2008 through 08/14/2011	08/15/2011 through 11/01/2015	11/02/2015 to Present
Civil Monetary Penalty Imposed By The Commission In An Administrative Action					
7 U.S.C. 9 (Section 6(c) of the Commodity Exchange Act)	For any person other than a registered entity*	\$130,000	\$1,000,000	\$1,025,000	\$1,212,866
7 U.S.C. 13a (Section 6b of the Commodity Exchange Act)	For a registered entity* or any of its directors, officers or employees	\$625,000	\$1,000,000	\$1,025,000	\$1,212,866
Civil Monetary Penalty Imposed By A Federal District Court In A Civil Injunctive Action					
7 U.S.C. 13a-1 (Section 6c of the Commodity Exchange Act)	Any Person	\$130,000	\$1,000,000	\$1,025,000	\$1,212,866
*The term "Registered Entity" is defined in 7 U.S.C. 1a (Section 1a of the Commodity Exchange Act).					

ENF Division Penalty Guidance – Framework

Three-Pronged Approach

- **Gravity of the Violation**

- **Mitigating and Aggravating Circumstances**

- **Other Considerations**

- A principles-based framework
 - **not a rigid formula** that applies specific numbers to particular actions
- In applying the factors, staff will be **guided by the overarching consideration of deterrence**
 - i.e., does the proposed penalty achieve the dual goals of specific and general deterrence
- Objective is to provide clarity and **achieve tough, fair, and consistent penalty results**

Three-Pronged Approach – Penalty Factors

Gravity of the Violation

- Nature and scope of the violations
- Respondent's state of mind (intentional or willful)
- Nature and scope of consequences flowing from the violations

Mitigating & Aggravating Circumstances

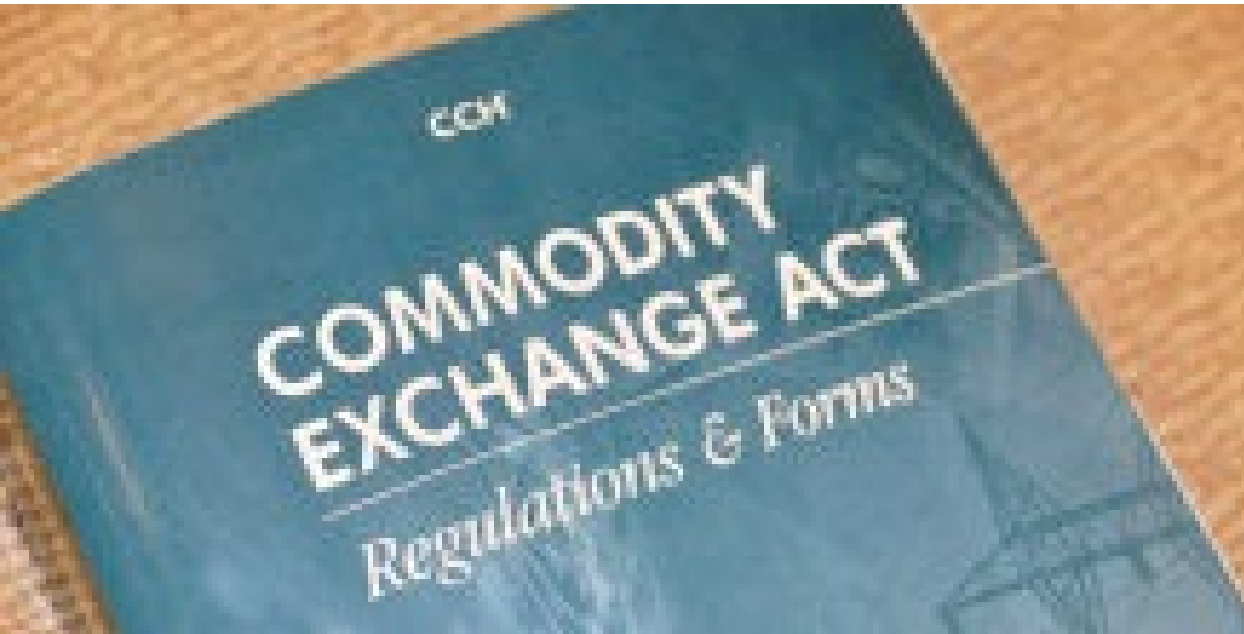
- Post-violation conduct
- Whether Respondent self-reported the misconduct
- Extent and timeliness of cooperation and remediation
- Existence and effectiveness of the company's pre-existing compliance program
- Prior misconduct
- Pervasiveness of misconduct within the company
- Disciplinary action taken by Respondent

Other Considerations

- The total mix of remedies and monetary relief imposed on Respondent in the Commission's enforcement action and parallel cases (DOJ, SEC, SROs, etc.)
- Monetary and other relief in analogous cases
- Conservation of Commission resources

Practical Considerations

Applying the CFTC Penalty Guidance



Know the penalty factors

Take mitigating actions now

Consider the factors early when problems arise

Evaluate the context

Are You a Commodity Pool?

Presented by Aaron Levy and Jon Ammons

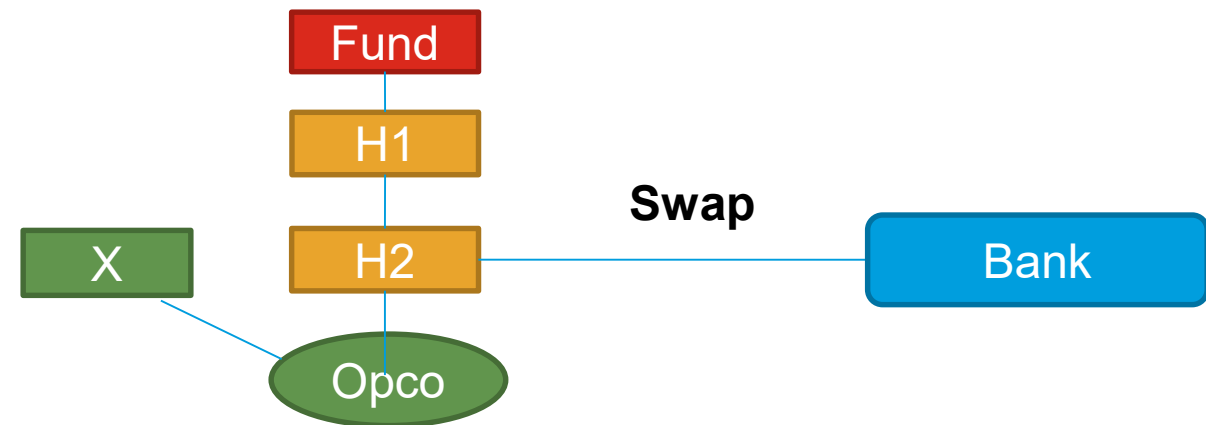
What is a Commodity Pool? Statutory Definition:

- “**Commodity Pool**” means any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in “**commodity interests.**” CEA § 1a(10)
- “**Commodity Interests**” includes (See CFTC Regulation 1.3):
 - Futures and options on futures traded on exchanges (e.g., CME, ICE), including security futures products based on a single security or narrow-based index;
 - Swaps (including forwards and OTC options), including swaps that are traded on a DCM (i.e., futures exchange) or on a SEF, and swaps traded on a bilateral basis; and
 - Leveraged or margined retail transactions (with non-ECPs) under section 2(c)(2) of the CEA.
 - ** No exception for hedging
 - ** Even a single trade may be sufficient
- “Commodity Interests” does **NOT** include:
 - Excluded FX transactions (i.e., “physically settled” FX forwards/swaps where two currencies are exchanged on a gross basis at settlement)
 - SEC-regulated products

What is a Commodity Pool?

In practical terms:

- Private Funds and other “Collective Investment Vehicles,” including co-investment vehicles, AIVs, wholly-owned subsidiaries, and other holding companies and SPVs formed to hold an investment or portfolio company **IF** either:
 - The Vehicle itself enters into commodity interest transactions
 - The Vehicle has *indirect exposure* to commodity interest positions at a subsidiary pool
- Master-Feeder Structure
- Does **NOT** include “Operating Companies”



What is NOT a Commodity Pool?

- “Commodity pool” does not include:
 - Portfolio company that is an operating company (or entities below it in the chain)
 - Single investor vehicle
 - Note: If the fund’s investment manager or its affiliate owns more than a de minimis equity interest in the fund itself, the CFTC takes the view that the fund is a pool
 - Any entity that does not either enter into derivatives or have indirect exposure to derivatives (via a subsidiary pool) – see entity “X” on prior slide
 - Any entity that enters into excluded derivatives only (e.g., excluded FX)
 - Entities that have been granted relief by the CFTC (see next slide)

CFTC No-Action and Interpretive Letters

- Relief from “commodity pool” definition:
 - CFTC Letter No. 00-89: Partnership owned by Iowa farmers, operated by a GP owned by a married couple and local farmers and employees. Revenues derived primarily from production/sale of hogs, derivatives traded solely for hedging its hog production costs.
 - Relief also granted to: (1) vehicles formed by close family members, long-term friends or business associates, (2) certain securitizations, (3) certain “equity REITs.”
 - CFTC Letter 17-68: Relief to asset manager operating large portfolio of real estate assets through various holding companies/SPVs, based on “significant similarities” to exempted equity REITs (in particular, its active involvement in leasing, maintaining, developing and managing the assets, as opposed to a passive financial interest).
 - Active vs. passive distinction; case-by-case, fact-specific.

CFTC No-Action and Interpretive Letters (cont'd)

- Relief to CPOs, including to certain:
 1. Funds of funds (if not possible to determine exposure to investee funds' swaps)
 2. Family offices
 3. BDCs
 4. Entities owning interests in crude oil/natural gas assets and hedge commodity price risks (active role in operating the assets)

CPO Registration and Exemptions

- If there is a commodity pool, then some person or entity must register as a CPO or satisfy an exemption from registration (e.g., § 4.13(a)(3))
 - *De Minimis* exemption from registration may be available if either:
 - (i) the aggregate initial margin/premium is $\leq 5\%$ of the liquidation value of the pool's portfolio [*typically used for futures or options*], or
 - (ii) the aggregate net notional value is $\leq 100\%$ of the liquidation value of the pool's portfolio [*typically used for futures or swaps*] and certain other conditions relating to investor sophistication, '33 Act exemption and marketing approach are satisfied
- CFTC Regulation 4.7 provides an exemption from many regulatory obligations (but not registration) for pools that limit investors to “qualified eligible persons” (e.g., qualified purchasers)

Primary Implications of Being a Registered CPO

- Regulatory Obligations
 - Registration with NFA (Form 7-R)
 - Registration of associated persons and listing of principals (Form 8-R; fingerprints)
 - Proficiency Examination for associated persons (including new exam for swaps activity)
 - Satisfaction of Disclosure Document requirements
 - Recordkeeping obligations (5 years)
 - Reporting obligations (Form CPO-PQR; NFA Form PQR; Form PF)
 - Annual questionnaire and self-evaluation questionnaire
 - Written policies and procedures
 - BCDR plan
 - Ethics training
 - Periodic NFA exams

Primary Implications of Being a Registered CPO (cont'd)

- Other implications
 - NFA members may generally only conduct business with persons or entities that are properly registered, exempt from registration, or are not required to be registered
 - Effectively requires CPOs to annually determine that their counterparties and investors satisfy these requirements
 - Strict liability for non-compliance
 - Financial entities / clearing exception and margin requirements
 - Commodity pools are by definition “financial entities”
 - As a result, they are ineligible for the end-user clearing exception, and are subject to CFTC’s margin requirements for uncleared swaps
 - Also potentially impacts swap data reporting hierarchy
 - ECP definition
 - Any person or entity entering into a swap must be an eligible contract participant (ECP). If a fund is engaging in retail FX transactions, all participants must also be ECPs, or the fund must satisfy a higher asset test

Hedging Structures for Gas-Fired Electric Generators

Presented by Jason Lewis

Hedging Structures to Be Considered

Part 1

Traditional Structures: PPAs and Tolls

Part 2

Revenue Puts

Part 3

Spark-Spread Swaps

Part 4

Heat-Rate Call Options

Part 5

Netbacks

Traditional Structures: PPAs and Tolls

PPAs

- Still the “Gold Standard”
- Locks in long-term fixed-price offtake
- Sponsor seeks long-term fixed-price gas supply
- Currently, difficult to find creditworthy long-term off takers

TOLLS

- Tolling party pays tolling fee plus costs (e.g., starts) and provides gas
- Fee supports payment of debt service
- Sponsor able to focus on development, ownership, operation
- Tolling party receives “upside” but wears outage risk and market risk
- Currently disfavored

Revenue Puts

- A financially-settled option common in Northeastern electricity markets
- Hedge provider sells an automatically exercised put option to sponsor
 - Sponsor pays premium (typically on a yearly basis)
 - Requires a monthly calculation of hypothetical revenues based on assumptions regarding facility
 - Generation owner deemed to exercise in months where the “proxy” revenues for the facility exceed the actual net revenues from power sales
- Option payment locks in a minimum level of revenues necessary to support debt service
- Premiums can be costly

Spark-Spread Swaps

- Floating-rate to floating-rate derivative transactions
- Hedge provider pays: proxy heat rate for the facility, times gas index plus a fixed amount representing the spark spread, times the applicable notional amount
- Sponsor pays: power index times the applicable notional amount
- Separately, sponsor sells at power index and buys gas at gas index, thereby locking in the spark spread per megawatt-hour
- Incentivizes efficient operations, as owner can try to “beat” the heat rate
- Typically not available for long terms, more commonly used post-financing

Heat-Rate Call Options (“HRCOs”)

- Sponsor sells a call option to the hedge provider
- Hedge provider pays a premium that provides revenue to support payment of debt service
- Hedge provider exercises option within set parameters (i.e., by a certain time each day, with a certain number of “starts”)
- Hedge provider pays a price for power based on a gas index multiplied by the sum of a proxy heat rate plus an assumed level of variable O&M costs
- Owner locks in revenue but relinquishes “upside” while wearing basis risk
- One recent market development is an “auto-exercise” feature that removes risk for hedge providers but commands a larger premium

Netbacks

- “Netback” is a familiar term in the energy industry, but is now being used to describe an increasingly popular structure for physical gas supply transactions where the price of gas is based on a power index
- Gas producer sells long-term gas supply to sponsor, with price typically based on a set percentage of the applicable hub or node on the power grid
- Mitigates “cross-commodity” risk
 - Gas price moves in tandem with the power index used to price sales of power
 - Advantageous because generally avoids negative spark spreads
 - Many netbacks include caps and floors on gas price, so do not eliminate this risk entirely
- Producers generally able to transact for longer terms than hedge providers, and often desire a long-term buyer

Comparison Chart

PPAs / Tolls

- PPAs still desirable, but more difficult to find creditworthy long-term off takers
- Tolls generally disfavored, market no longer perceives outsize opportunity for tolling parties

Revenue Puts

- Financially settled put options
- Sponsor receives positive difference of proxy minus actual revenues
- Provides minimum level of revenue for sponsor
- Requires sponsor to pay a premium

Spark-Spread Swaps

- Float-for-float swap transactions to lock in spark spread
- Hedge provider pays based on heat rate times gas price plus spark spread
- Sponsor pays based on power index
- Typically shorter tenors

HRCOs

- Sponsor sells call option on power
- Hedge provider pays premium plus price based on heat rate times gas price
- Sponsor loses “upside” in high-priced hours, still subject to other risks

Netbacks

- Long-term physical sales of gas at price based on power index
- Mitigates cross-commodity risk, but many transactions have caps and floors
- Producers often willing to transact for longer terms

Dodd-Frank at 10 Years

Presented by Michael O'Brien

Highlights

- Mandatory Clearing of Swaps and Security Based Swaps (Futures Model)
 - Derivatives Clearing Organizations (DCOs) and Swap Execution Facilities (SEFs)
 - Clearing Determinations – Certain IR Swaps and Credit Default Swaps
 - Exemptions to Clearing
- Registration of Swap Dealers
 - Business Conduct Rules including enhanced KYC (Protocols vs. Bi-Laterals)
- Reporting and Recordkeeping Requirements
 - GMEIs and LEIs; Swap Data Repositories (SDRs)
 - CFTC Weekly Swap Report; Cleared Margin Reports

Highlights (continued)

- Margin for Uncleared Swaps
 - Variation Margin
 - Initial Margin – Phases 1 through 4 in effect
- Systematically Important Financial Institutions (SIFIs)
 - More Regulatory Scrutiny; Higher Capital Requirements
 - Threshold Rolled Back Somewhat in 2018
- Orderly Liquidation Authority
 - Resolution Stay for QFC

To Be Implemented

- Initial Margin – Phase 5 (50-750 bn Average Daily Notional Amounts) – September 1, 2021; Phase 6 (8-50 bn AANA) – September 1, 2022
- CFTC Position Limits – Reproposed Rule
- Other Clearing Determinations – FX, NDFs?
- Security Based Swaps – Rules Announced But Most Not In Effect Until 2021

Enforcement

- CFTC – Focus To Date on Swap Data Reporting Violations, Recordkeeping Violations
- Deutsche Bank Consent Order June 17, 2020
 - Reporting Violations
 - Prior CFTC Order (2015) from failure to report Swap cancellations
 - 2016 Platform Outage During Upgrade – 5 Days of No Reporting, Subsequent Reporting Errors
- \$9,000,000 Civil Fine – Permanent Injunction from Violations

HERE TO STAY?

Questions?



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Thank you for attending

Our Team



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& STRAWN
LLP

Speakers



Michael O'Brien

Chair, Derivatives and Structured Products
Chicago
(312) 558-8097
mpobrien@winston.com



Michael Loesch

Partner
Washington, D.C.
(202) 282-5638
mloesch@winston.com



Jon Ammons

Of Counsel
Washington, D.C.
(202) 282-5662
jammons@winston.com



Aaron Levy

Of Counsel
New York
(212) 294-5332
alevy@winston.com



Jason Lewis

Of Counsel
New York
(212) 294-4679
jalewis@winston.com
