

Current Issues in Derivatives

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Security-Based Swaps – Regulatory Developments, Documentation and the ISDA US Self-Disclosure Letter

Presented by Jon Ammons

Security-Based Swap Regulations: Regulatory Developments

Compliance Dates

- On August 6, 2021,* entities must begin counting the aggregate gross notional amount of security-based swap (SBS) positions connected with SBS dealing activities
 - Once an entity exceeds the *de minimis* amount, it must register as an SBSD within two months of the end of the month in which it was exceeded
 - November 1, 2021 for entities that exceed the threshold in August 2021, but can apply earlier
 - *De minimis* thresholds are \$8 billion for CDS and \$400 million for other SBSs (to be lowered to \$3 billion and \$150 million after expiration of phase-in)

*Limited exceptions apply

Regulations Triggered by Registration

- SBS Entity segregation requirements and nonbank SBS Entity capital and margin requirements
- SBS Entity recordkeeping and reporting requirements (different from SBSR)
- SBS Entity business conduct standards
- SBS Entity trade acknowledgment and verification requirements, and
- SBS Entity risk mitigation requirements

Reporting Requirements Generally

- Regulation SBSR generally requires SBS data to be reported within 24 hours of execution
- The compliance date for Regulation SBSR is the first Monday that is the later of:
 - 6 months after the date on which the first SDR that can accept transaction reports in that asset class registers with the SEC; or
 - one month after the compliance date for registration of SBSDs
- In its Cross-Border Rule, the SEC provided no-action relief from certain aspects of the reporting requirements — generally to allow parties to follow CFTC reporting rules

ISDA 2021 SBS Top-Up Protocol

Overview

- Adherence to the ISDA SBS Top-Up Protocol is not mandated by law, it is an industry solution
- It can only be used by counterparties who have previously adhered to the August 2012 and/or March 2013 DF Protocols
 - ISDA is developing a separate “Full” or “Long Form” SBS Protocol for other counterparties
- In general, the Top-Up Protocol incorporates relevant portions of the DF Protocols and updates language to refer to SBS, and adds additional notices, representations and covenants necessary under SEC regulations
 - Relates to reporting and dissemination of SBS information, business conduct standards for SBSDs, trade acknowledgment, risk mitigation techniques and the cross-border application of certain SBS requirements

Top-Up Protocol Components

Protocol:

1. Information regarding effect of submitting an adherence letter
2. Incorporates Appendix 1 if parties previously adhered to August 2012 Protocol and the SBSD designates Appendix 1 as applying
3. Incorporates Appendix 2 if parties previously adhered to March 2013 Protocol and the SBSD designates Appendix 2 as applying

Adherence Letter:

1. Form letter indicating an entity's participation in the protocol
2. Submitted through electronic portal
3. Available for public view

Appendices:

1. Set forth standardized reps, acknowledgments, notifications and agreements
2. Appendix 1 generally relates to business conduct standards and cross-border rules
3. Appendix 2 generally relates to trade acknowledgment and risk mitigation rules

No Questionnaire is included

Appendix 1 Components

- Incorporation of relevant portions of August 2012 ISDA DF Protocol
 - General representations
 - Delivery and notifications
 - Daily marks
 - Hedging representations
- Privacy issues and disclosure of information to trade repositories
- Disclosures re: daily marks, clearing and choice of clearing agency
- Safe Harbors for “recommendations” by SBSDs
 - Different representations required depending on whether CPs previously incorporated Schedule 3 (available to all persons), Schedule 4 (governmental special entities), Schedule 5 (ERISA special entities) or Schedule 6 (ERISA special entities)

Appendix 2 Components

- Incorporation of relevant portions of March 2013 DF Protocol
 - General representations
 - Creation of confirmations as defined in regulations
 - Acknowledgment of FDIC's authority to transfer under the Orderly Liquidation Authority
- Updates to language if parties adopted a deemed ISDA through the March 2013 DF Protocol
- Incorporation of disclosure language related to the calculation of risk valuations and dispute resolution procedures
- Incorporation of disclosure language related to the procedures for conducting portfolio reconciliation

ISDA US Self-Disclosure Letter

Overview

- The 2021 ISDA Self-Disclosure Letter is intended to facilitate the exchange of information between market participants to determine whether compliance with certain SBS rules is required
 - In particular, whether an entity must comply with CFTC and/or U.S. banking agency swap regulations and/or SEC SBS regulations
- To some extent supersedes the ISDA Margin Self-Disclosure Letter (2016) and the ISDA Cross-Border Swaps Representation Letter (2013)

Topics

- Registration status
- Jurisdictional connection
 - Residence
 - 2020 Cross-Border Rules (CFTC)
 - 2013 Interpretive Guidance (CFTC)
 - CFTC Margin Rules
 - PR Margin Rules
 - Multi-branch entities
- Exemption from margin rules
 - CFTC/PR Rules
 - SEC Rules
- Financial entity status

LIBOR Transition Update

Presented by Aaron Levy

IBA and FCA Announcements (March 5)

- IBA Feedback Statement on Consultation on Potential Cessation of LIBOR
 - Consultation (Dec 2020) requested feedback on cessation dates:
 - 12/31/2021: GBP, EUR, CHF and JPY LIBOR (all tenors) and USD LIBOR (1 week, 2 month)
 - 6/30/2023: USD LIBOR (overnight and 1 , 3 , 6 and 12 month)
- FCA Announcement on Future Cessation of LIBOR
 - “Trigger Event”
 - “Spread Adjustment Fixing Date” under Bloomberg IBOR Rule Book
- FCA Policy Statements (use of proposed powers under UK Financial Services Bill)
 - Designating an unrepresentative benchmark (Article 23A)
 - Requiring changes to a critical benchmark’s methodology (Article 23D)
 - “Synthetic LIBOR” for certain “tough legacy” contracts
- Any synthetic LIBOR settings will not be considered “representative”

New York Legislation for “Tough Legacy” Contracts

- Replaces USD LIBOR “by operation of law” with SOFR-based benchmark in any (NY law governed) contract, security or instrument that uses LIBOR as a benchmark and:
 - (a) contains no fallback provisions; or
 - (b) contains fallback provisions that result in a benchmark “based in any way on any LIBOR value”
- Replacement occurs upon cessation of USD LIBOR or “non-representative” statement
- SOFR-based benchmark is a “commercially reasonable replacement” for USD LIBOR
- Transition will not impair any party’s right to payments, excuse performance, constitute a breach or nullify a contract
- Safe harbor from litigation
- Parties may opt out or select alternative benchmark replacement

New York Legislation for “Tough Legacy” Contracts (cont’d.)

- Concerns remain:
 - Conflict with Trust Indenture Act’s unanimous consent requirement
 - Section 316(b): “the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security ... shall not be impaired or affected without the consent of such holder”
 - Constitutional issues (Due Process, Takings and Contracts Clauses)
 - Contracts governed by other states’ laws
 - Federal legislation (?)
 - Cross-Border Conflicts
 - UK: Financial Services Bill
 - EU: Benchmark Regulation (EU) 2016/1011

ARRC Abridged “Hardwired” Fallback Language

- Supplements and simplifies 2020 recommended fallback language for syndicated and bilateral loans
- Seeks to facilitate adoption of SOFR-based benchmark and hardwired fallback language by filling in blanks and streamlining language
- Same substantive result as 2020 language
- Simplifies trigger events (given occurrence of ‘Benchmark Transition Event’ and certainty regarding cessation dates)
- Spread adjustment values (fixed on March 5) incorporated into ‘Benchmark Replacement’ definition (eliminates ‘Benchmark Replacement Adjustment’)
- For loans that transition to Daily Simple SOFR (2nd step in waterfall, absent Term SOFR), specifies payment period and thus clarifies spread adjustment

U.S. Margin Rule Updates for Uncleared Swaps

Presented by Daniel Bley

Overview

- Swap dealers (SDs) and major swap participants (MSPs) are required to collect and/or post initial margin (IM) and variation margin (VM) for uncleared swaps after the relevant compliance date
 - Swaps where neither party is an SD or MSP are not subject to margin rules
 - NDFs and FX options are subject to margin requirements, but deliverable FX forwards and FX swaps are excluded
- CFTC and prudential regulators (e.g., Federal Reserve Board) have separate margin rules — largely similar but with certain differences
 - Which rules apply depends on whether the SD or MSP is regulated by a prudential regulator (in which case those rules apply) or not (in which case the SD or MSP is a “covered swap entity” (CSE), and the CFTC rules apply)

Swaps Subject to Margin Rules

- Margin requirements apply to all swaps SDs and MSPs enter into with other SDs or MSPs, and certain swaps with financial end-user counterparties

	SD or MSP	Financial end-user with “material swaps exposure”	Financial end-user <u>without</u> “material swaps exposure”	Non-financial end-user
Initial Margin	X	X		
Variation Margin	X	X	X	

- Financial end-users are entities other than CSEs, including financial institutions, funds, insurance companies and related entities engaged in financial activities
- Swaps with non-financial end-users are excluded

Original Compliance Schedule

Notional Amount of Swaps Both Counterparties Have	IM Compliance Date	VM Compliance Date
> \$3 trillion	September 1, 2016	September 1, 2016
> \$2.25 trillion	September 1, 2017	March 1, 2017
> \$1.5 trillion	September 1, 2018	
> \$750 billion	September 1, 2019	
> \$8 billion	September 1, 2020	
≤ \$8 billion	N/A	

- The IM compliance date for Phase 5 — the final phase, where “material swaps exposure” exceeds \$8 billion — was originally scheduled for September 1, 2020
- All VM compliance dates have now occurred

April 2020 Final Rule

Notional Amount of Swaps Both Counterparties Have	IM Compliance Date
> \$3 trillion	September 1, 2016
> \$2.25 trillion	September 1, 2017
> \$1.5 trillion	September 1, 2018
> \$750 billion	September 1, 2019
> \$50 billion	September 1, 2020
> \$8 billion	September 1, 2021
≤ \$8 billion	N/A

- Split what was Phase 5 into a new Phase 5 and Phase 6
- Extended new Phase 6 compliance deadline to September 1, 2021

July 2020 Interim Final Rule

Notional Amount of Swaps Both Counterparties Have	IM Compliance Date
> \$3 trillion	September 1, 2016
> \$2.25 trillion	September 1, 2017
> \$1.5 trillion	September 1, 2018
> \$750 billion	September 1, 2019
> \$50 billion	September 1, 2021
> \$8 billion	September 1, 2021
≤ \$8 billion	N/A

- Deferred new phase 5 compliance deadline to September 1, 2021, in light of pandemic

November 2020 Final Rule

Notional Amount of Swaps Both Counterparties Have	IM Compliance Date
> \$3 trillion	September 1, 2016
> \$2.25 trillion	September 1, 2017
> \$1.5 trillion	September 1, 2018
> \$750 billion	September 1, 2019
> \$50 billion	September 1, 2021
> \$8 billion	September 1, 2022
≤ \$8 billion	N/A

- Deferred new phase 6 compliance deadline to September 1, 2022, to implement intent behind April 2020 Final Rule

Related Updates

- Minimum Transfer Amount (Final Rule)

- Generally, the maximum MTA is \$500K (aggregate of IM and VM exposure)
- For separately managed accounts (SMAs), CSEs can apply an MTA of up to \$50K, with separate MTAs for IM and VM exposure, for each SMA

- Calculation of “Material Swaps Exposure” (Final Rule)

“As of September 1 of any year, the entity and its margin affiliates have an **average month-end** [changed from daily] aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps with all counterparties for **March, April, and May of that year** [changed from June, July and August of the **prior** year] that exceeds \$8 billion, where such amount is calculated only for the last business day of the month”

- Legacy Swap IBOR Amendments (CFTC No Action Letter)

- Amendments to IBOR-referencing legacy uncleared swaps solely to (i) include new fallbacks triggered by permanent discontinuation/determination that such IBOR is non-representative or (ii) accommodate replacement of such IBOR are “Qualifying Amendments” that will not cause the amended swap to be subject to the margin rules

Primary Implementation Issues

- Large number of entities remaining in scope
 - While Phases 1 through 4 (2016 through 2019 deadlines above) captured approximately 40 entities in the aggregate, Phases 5 and 6 will bring into scope approximately 670 new entities and 7,500 IM relationships
- Internal assessments of requirements
- Documentation
 - Need to update CSAs and other documents to account for new margin rules
- Custodians
 - Need to establish custodial relationships for margin
- Type of margin and haircuts
 - Need to work through the type of collateral counterparties intend to post and determine appropriate haircuts

ISDA E-Documentation

Presented by Jason Lewis

Topic Outline and Summary of Discussion

Part 1

Background – Smart Derivatives Contracts

Part 2

“ISDA Create”

Background – Smart Derivatives Contracts

- Significant potential benefits to derivatives market from advancing technologies
 - E.g., distributed ledger technology and smart contracts
- So how to adapt derivatives documentation to realize benefits of future technological development?
 - Can payments, covenants, representations, defaults, closeouts, security be automated?
 - Multiple layers of docs (e.g., masters, confirmations, schedules, annexes, protocols)
 - High degree of individual negotiation often required
- ISDA “FpML,” “Common Domain Project,” and “Legal Guidelines for Smart Derivatives Contracts”

“ISDA Create”

- New electronic platform that automates the creation of certain ISDA documentation
 - 1992 ISDA, 2002 ISDA, ISDA amendments, initial margin, benchmark reform (including ISDA IBOR Fallbacks Supplement and IBOR Fallbacks Protocol)
 - Allows parties (and their advisors) to negotiate on the platform
 - Allows parties to create final documentation and execute it on the platform
 - Allows parties to track negotiations and data from their documentation portfolio
 - Allows parties to customize their documentation by using the “ISDA Clause Library”
 - Contains a wide range of standardized, coded versions of typical elections and variables
 - Includes common ATEs related to NAV triggers, changes of control, ownership maintenance
 - Still a work in progress

Conclusion



“

It's tough to make predictions, especially about the future.

- Yogi Berra

CFTC Final Cross-Border Rules (17 CFR 23.23)

Presented by Michael O'Brien

Background

Context

- Section 2(i) of CEA — Title VII (including the rules and regulations) shall not apply to activities outside the US unless (i) direct and significant connection with activities in, or effect on, commerce of the US or (ii) such activities contravene rules or regulations necessary or appropriate to prevent evasion of the Title VII swap provisions

Purpose

- Registration — to non-US swap dealers/major swap participants — which swaps to include in calculating whether swap dealing activities exceed the *de minimis* threshold for registration with CFTC
- Applicability of certain DF Requirements — to non-US swap dealers/MSPs that are CFTC registered — How various DF requirements apply to swaps outside the US — includes new grouping of prior entity level and transaction level
- Comparability — to non-US swap dealers/MSPs that are CFTC registered — Establish a formal process for requesting comparability determinations

Additional Background

- Reliance on Representations unless know, or have reason to know, not accurate
- Implications — for non-dealers/non-MSPs entering into swaps with non-US swap dealers/MSPs that are CFTC registered — expect changes in representations/KYC information required to provide as a condition to trade
- Supersedes 2013 Cross Border Guidance, 2013 staff advisories and various no-action letters including those concerning so-called ANE Transactions (arranged, negotiated and executed by US personnel)
- No effect on May 2016 Cross-Border Margin Rules
- Effective Date — November 13, 2020
- Compliance Date — Applies to swaps executed on or after September 14, 2021

Key Definitions

U.S. Person

- Includes (i) natural person resident in the US; and (ii) partnership, corporation, trust, investment vehicle or legal person (A) organized, incorporated or established under the laws of the US or (B) having principal place of business in the US. Excludes certain IFIs such as IMF. Does not include legal entities for which US persons bear unlimited responsibility for obligations, such as Canadian unlimited liability companies. Abandons look-through for collective investment vehicles — i.e., majority ownership by US persons is not determinative of US person.

Principal Place of Business

- Location from which officers or managers primarily direct, control and coordinate activities of the legal entity. CIV has a principal place of business in the US if senior personnel responsible for implementation of investment strategy are located in US.
- For purposes of classification of a counterparty, until December 31, 2027 entity may rely, for legacy trades, on representations made in respect of the definition of “US person” under prior CFTC Guidance and interpretations.

Significant Risk Subsidiary

- Non-US entity that is (i) a “significant subsidiary” of ultimate US parent entity that has more than \$50 billion in global consolidated assets and (ii) not supervised by the Fed or a home country regulator. “Significant subsidiary” — test on 3 year rolling average — equity capital equal to or greater than 5% of equity capital of ultimate US parent; or revenue or assets equal to or greater than 10% of revenue or assets, respectively, of ultimate US parent. Similar to SEC Reg S-X; Fed financial statement filing requirements

Guarantee

- Arrangement in which one party to a swap has rights of recourse (legal enforceable right to receive or collect payment) against a guarantor with respect to the obligations of the counterparty to the swap. For purposes of classification of a counterparty, until December 31, 2027 entity may rely, for legacy trades, on representations made in respect of the definition of “guarantee” under prior CFTC Guidance and interpretations.

Foreign-Based Swaps

- Swap entered by non-US dealer/MSP that is CFTC registered unless booked in a US branch; or swap conducted through a foreign branch

Regrouping of prior Entity Level Requirements and Transaction Level Requirements

- Group A Requirements — chief compliance officer; risk management (e.g., internal policies and procedures); swap data recordkeeping and antitrust — substituted compliance may be available
- Group B Requirements — swap trading relationship documentation; portfolio reconciliation and compression; trade confirmation; daily trading records
- Group C Requirements — external business conduct rules; elective initial margin segregation

Registration

Registration

- For purposes of determining whether swap activity exceeds the *de minimis* threshold for registration with the CFTC:
 - A US person or a Significant Risk Subsidiary includes all swaps (whether US or non-US) connected with its dealing activity
 - A non-US person (other than an SRS) includes all swaps with a US person (except swaps through a foreign branch of a registered SD), all swaps where the obligations of such person are guaranteed by a US person, all swaps where the counterparty obligations are guaranteed by a US person (except where counterparty is a registered dealer, the counterparty guarantor is a non-financial entity or counterparty is affiliated with a registered dealer but below the *de minimis* threshold)
 - Exclusions — swaps by non-US person entered on a DCM or SEF and cleared where counterparty is not known

Exemption from Certain DF Requirements

Exemption from Certain DF Requirements

- Exemptions are available now subject to specified recordkeeping requirements
- Each non-US swap dealer/MSP that is CFTC registered is:
 - Exempt from most Group B Requirements and all Group C Requirements — any foreign-based swap that is entered on a DCM, SEF or foreign board of trade, cleared through a registered DCO and where identity of counterparty is not known prior to execution
 - Exempt from Group C Requirements — any foreign based swap with a foreign counterparty; any swap booked in US branch with foreign counterparty that is neither a foreign branch nor person guaranteed by US person
 - Exempt from Group B Requirements — any foreign based swap if neither SRS nor guaranteed by US person and swap with foreign counterparty (other than a foreign branch) which is not SRS or guaranteed by US person

Exemption from Certain DF Requirements

(cont'd.)

- Each non-US swap dealer/MSP that is CFTC registered is:
 - Exempt from Group B Requirements — any foreign based swap if foreign branch of US swap entity in respect of swap with foreign counterparty (other than foreign branch) that is not guaranteed by US person unless eligible for substituted compliance and, in any quarter, not in excess of 5% of aggregate gross notional of swaps
 - Exempt from Group B Requirements — if SRS or guaranteed by US person in respect of swap with foreign counterparty (other than foreign branch) that is not guaranteed by US person unless eligible for substituted compliance and subject to 5% quarterly limit
 - Group A Requirements may be satisfied by substituted compliance
- CFTC No Action Letter 21-09, April 7, 2021 – Brexit – Deemed comparability determination for UK for purposes of exemption from Group B Requirements

Comparability Determinations

Comparability Determinations

- CFTC may issue comparability determinations on its own initiative or upon the request of swap entity that is eligible for substituted compliance or foreign regulatory authority. Submission requirements include statement of objectives of relevant foreign jurisdiction standards and products and entities subject to such standards. CFTC determination of whether comparable to CFTC corresponding requirements or groups of requirements. Compliance with foreign jurisdiction standards that are deemed comparable is deemed compliance with relevant CFTC standards.

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Thank you for attending