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6th digital OTC Derivatives Seminar

Managing Crisis and Transition

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Welcome from our Speakers

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Agenda

Session 1
LIBOR transition projects and upcoming document landscape
Equity derivatives in the current market environment
Session 2
• EMIR update and update on Initial Margin implementation • EMIR II FRANDT principles for client clearing agreements and impacts on existing template documentation
• Coronavirus Crisis I: Impacts on derivatives • Coronavirus Crisis II: Preparation for defaults under Master Agreements and Credit Derivatives
Brexit preparations
Questions & Discussion

Anna Pinedo, Chris Arnold, Ed Parker, Patrick Scholl

LIBOR transition projects and upcoming document landscape

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LIBOR and the Transition to SOFR in the US

- USD LIBOR's Replacement Reference Rate: The Secured Overnight Financing Rate (SOFR)
  - On June 22, 2017, the Alternative Reference Rates Committee (ARRC) identified SOFR as its recommended alternative to USD LIBOR
  - SOFR is a broad measure of the cost of borrowing cash overnight **collateralized by U.S. Treasury Securities**
  - SOFR is determined based on **transaction data** composed of:
    - Tri-party repurchase agreements (repo)
    - General Collateral Finance repo
    - bilateral Treasury repo transactions cleared through Fixed Income Clearing Corporation

LIBOR and the Transition to SOFR in the US

- SOFR is believed to be a good representation of general funding conditions in the overnight Treasury repo market
- SOFR encompasses a robust underlying repo market with more than **$700 billion** in daily transactions

LIBOR and the Transition to SOFR in the US

- Key differences between LIBOR and SOFR
  - SOFR is a risk free rate, LIBOR is not
    - SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury Securities
    - LIBOR is an average of panel banks' costs of funding
  - SOFR likely will be a lower rate than LIBOR
  - SOFR is likely to behave differently than LIBOR
    - LIBOR widens in periods of stress while SOFR likely will not
  - Risk of **value transfer** without spread adjustments
    - Static vs. dynamic modifiers

LIBOR and the Transition to SOFR in the US

- SOFR is an overnight rate and changes daily; LIBOR is a term rate, most commonly quoted for 1 or 3 month(s)
- SOFR is backward looking; LIBOR is forward looking

Consequences under existing ISDA Definitions

- Fallbacks under 2006 ISDA Definitions for USD-LIBOR (if "rate for deposits in U.S. dollars" does not appear on the specified screen):
  - Rate at which USD deposits are offered by the Reference Banks at approximately 11:00 am, London time, … to prime banks in the London interbank market for a period of the Designated Maturity …
  - If fewer than 2 quotations, then the Calculation Agent looks to quotations of major banks in New York City for loans in USD to leading European banks
  - No further fallbacks if quotes for these interbank loans are not available

Consequences under existing ISDA Definitions

- What happens when fallbacks run out?
  - New York common law on gap-filling, frustration, impossibility, force majeure, etc.

ISDA Consultations on IBOR Fallbacks for 2006 ISDA Definitions

- There were various ISDA consultations regarding the transition
- Results summarized in Brattle Group Report, Nov. 2019
  - Vast majority of respondents to the first 2 consultations favored a "***compounded setting in arrears rate***" and historical mean/median approach to credit spread adjustment
  - Majorities of respondents to Final Parameters Consultation favored ***historical median with 5-year lookback***, no transitional period, no exclusion of outliers or negative rates, and two banking-day backward shift for operational and payment purposes

ISDA Consultations on IBOR Fallbacks for 2006 ISDA Definitions

- The premise of the consultations was that the floating rate options will be revised to include fallbacks that will be triggered ***upon the permanent discontinuation*** of the related IBORs, as evidenced by a public statement by the administrator of the IBOR or the administrator's regulatory supervisor
- Bloomberg was chosen as the adjustment services vendor to calculate and publish the term and spread adjustments for fallbacks based on ISDA's adjustment methodology (credit adjustment spread for fallbacks on cessation of LIBOR would be a historical median over a 5-year lookback)

ARRC Consultation on whether to Recommend Swaption Compensation Mechanism

- CME and LCH have announced a compensation mechanism for cleared swaps in existence at the time of the EFFR-to-SOFR discounting transition (expected October 2020), comprising cash compensation for the change in valuation and a risk exchange (in the form of a basis swap or possibly its cash equivalent)
  - This specific mechanism, however, would not create any compensatory transfers between the parties to a swaption unless the swaption has been exercised into a cleared swap by the transition date

ARRC Consultation on whether to Recommend Swaption Compensation Mechanism

- In February 2020, ARCC conducted a consultation. Recommendations were released in May 2020, that, on a portfolio basis, market participants voluntarily:
  - Amend legacy swaptions expiring after October 16, 2020 to be brought in-scope for ISDA Supplement 64 and to specify SOFR as the Agreed Discount Rate
  - Exchange compensation for the difference in the value of these swaptions between EFFR discounting and SOFR discounting

ARRC Consultation on whether to Recommend Swaption Compensation Mechanism

- ARCC recommendation is intended to apply to swaptions traded prior to March 30, 2020
- For new swaptions, the ARCC recommends market participants specify at time of trade an Agreed Discount Rate of:
  - The effective federal funds rates if the swaption expires on or prior to October 16, 2020
  - SOFR if the swaption expires after October 16, 2020

Regulatory Issues under Dodd-Frank Title VII

- Compliance burden and economic costs if amendments to include fallbacks or replace rate trigger the application of regulatory requirements. See ARRC Title VII Letter to U.S. regulators (July 2018)
  - Loss of grandfathered status under uncleared margin and (if CFTC extends mandates to SOFR) clearing and trade execution?
  - Triggering of swap dealer business conduct rules
  - Swap trading relationship documentation, confirmations
  - Real-time reporting
  - Swap data reporting, portfolio reconciliation

Regulatory Issues under Dodd-Frank Title VII

- BCBS/IOSCO Statement on Margin Implementation (March 2019):
  - "Amendments to legacy derivative contracts pursued solely for the purpose of addressing interest rate benchmark reforms do not require the application of the margin requirements for the purposes of the BCBS/IOSCO framework, although the position may be different under relevant implementing laws"

Prudential Regulators' Proposal to preserve Legacy Status under Margin Rules for Swap Amendments

- On September 17, 2019, the OCC, FDIC, FRB, FCA and FHFA issued a notice of proposed rulemaking that would amend the Swap Margin Rule to permit a covered swap entity to amend a legacy swap in order to replace an IBOR with an alternative reference rate or rates, without triggering margin requirements
  - Flexible with respect to method and execution of amendment; permits benchmark to be replaced more than once
  - Describes the type of rate that can be replaced and the accompanying contractual and technical changes that would be permitted
  - Designed to encourage covered swap entities to resolve critical uncertainties before an interest rate benchmark is discontinued and markets are disrupted

CFTC No-Action Relief to Facilitate LIBOR Transition

- Three divisions of the CFTC issued no-action letters in December 2019
  - DSIO Letter 19-26 provides relief on swap dealer *de minimis* requirements, uncleared swap margin, business conduct (*but not certain pre-trade disclosure*), confirmation, documentation and certain other requirements.
  - DMO Letter 19-27 provides time-limited relief from the trade execution requirement
  - DCR Letter 19-28 provides time-limited relief from the swap clearing requirements and related exceptions

Expectations for 2020

- ISDA publication of amendments to the 2006 ISDA Definitions to incorporate adjusted RFR fallbacks in new contracts
- ISDA protocol to enable market participants to include the amended 2006 ISDA Definitions with fallbacks in legacy IBOR contracts (expected in July 2020)
- In order to promote SOFR liquidity in the cleared swaps market, there will be a change of discounting and price alignment interest by central counterparty clearinghouses (CCPs) (coordinated with LCH's transition plan and referred to as the "big bank") for cleared USD interest rate swaps from Effective Federal Funds Rate to SOFR (October 16, 2020)
- ARCC published best practices in late May 2020 for completing the financial industry's transition from LIBOR; market participants should fully cease using USD LIBOR in new products no later than June 30, 2021

Practical Questions

- Conduct and relationship risk for dealers
  - Disclosure of pricing methodology, material risks
  - Sufficiency of simple spread adjustment to address value transfer in non-linear and complex products? Are there any known systematic biases?
  - Need for further adjustments (volatility, correlation, convexity)?
- Effect on specific products – constant-maturity swap rates, swaptions, caps, floors, forward rate agreements, in-arrears swaps
- Consensual close-out and rebooking in advance of 2021. When will the LIBOR forward curve cease to be a robust mechanism for pricing early termination?

Practical Questions

- How will counterparties assess the trade-offs between hedge basis risk and transaction costs? Increased requests for scenario analysis?
- How are hedging covenants in credit agreements drafted? Flexible enough to permit, e.g., hedging LIBOR with SOFR OIS, or FLTR with SOFR OIS?

Amendments to BMR

- 23 June – HM Treasury announced that it intends to bring forward legislation to amend the Benchmarks Regulation (BMR) to give the FCA enhanced powers.
- These could help manage an orderly wind-down of critical benchmarks such as LIBOR.

Cessation and Pre-Cessation Triggers and Adjustment Spreads

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Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA Definitions

Consultation on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR,[1] CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW

Executive Summary

- ISDA is amending its standard documentation to implement fallbacks for certain key IBORs.
- The fallbacks will apply if the relevant IBOR is *permanently discontinued*, based on defined triggers.
- The fallbacks will be to alternative risk-free rates (RFRs) that have been identified for the relevant IBORs as part of recent global benchmark reform work.
- **This consultation seeks input on *the approach for addressing certain technical issues* associated with adjustments that will apply to the RFRs if the fallbacks are triggered. These adjustments are warranted because of the differences between the IBORs and the RFRs.**
- This consultation covers GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW. ISDA will launch supplemental consultations covering USD LIBOR, EUR LIBOR and EURIBOR but requests preliminary feedback on the technical issues associated with fallbacks for these benchmarks in this consultation.[2]
- Based on responses to this consultation, ISDA will determine the style of approach to implement. ISDA will then work with an independent third-party vendor (selected pursuant to a formal request-for-proposal process) to build out and finalize the approach. Before implementing any changes to its standard documentation, ISDA will publish the final approach for review and comment.

ISDA

May 16, 2019

Consultation on Pre-Cessation Issues for LIBOR and Certain Other Interbank Offered Rates (IBORs)

Executive summary

- ISDA intends to amend its standard documentation to implement fallback reference rates ("fallbacks") for certain key IBORs, including LIBOR, to protect against the risk that those IBORs could cease at some point in the future. Specifically, ISDA intends to amend and restate the 'rate options' in the 2006 ISDA Definitions to ensure that, in the event certain IBORs cease, the fallbacks will apply to derivative transactions that are entered into on or after the effective date of the amendments and incorporate the 2006 ISDA Definitions. ISDA also expects to publish a protocol to facilitate inclusion of the fallbacks in pre-existing derivative transactions which incorporate the 2006 ISDA Definitions, the 2000 ISDA Definitions or which otherwise reference a relevant IBOR in the related ISDA master agreement or ISDA credit support documentation.
- Recent statements by the UK Financial Conduct Authority (FCA) suggest that market participants may wish to consider including in their LIBOR contracts "pre-cessation" fallback triggers based on an announcement by the FCA that LIBOR is no longer representative, in addition to fallback triggers based on permanent cessation.[1]
- Certain public-private sector RFR working groups, such as the Alternative Reference Rates Committee (ARRC) in the United States, have consulted on and published template fallback language for new cash products which includes non-representative "pre-cessation" triggers.
- In March 2019, the Financial Stability Board (FSB) Official Sector Steering Group (OSSG) co-chairs wrote to ISDA encouraging ISDA to seek market opinion on the events that should trigger a move to a spread-adjusted fallback rate for LIBOR.[2]

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Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA Definitions

Consultation on Final Parameters for the Spread and Term Adjustments in Derivatives Fallbacks for Key IBORs

Background

In July 2016, the Financial Stability Board's Official Sector Steering Group (FSB OSSG) asked ISDA to participate in work to enhance the robustness of derivatives contracts referencing widely used benchmarks. The FSB OSSG's objectives were for market participants to understand the fallback arrangements that would apply if key IBORs were permanently discontinued, and for the arrangements to be robust enough to prevent potentially serious market disruptions. If an IBOR is not available (including if it is permanently discontinued), current fallbacks under the 2006 ISDA Definitions generally require the calculation agent to obtain quotations from major banks in the relevant interbank market.[1] If, however, an IBOR is permanently discontinued, it is unlikely that major banks would be willing and/or able to provide these quotations. Even if interbank market quotations could be obtained in the near-term after a permanent discontinuation, it is unlikely that they would be consistent (or even similar) across markets. It is even more unlikely that they would be available on each future reset date over the remaining tenor of long-dated contracts. Further, it also is likely that quotations could vary materially across the market.

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December 18, 2019

Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA Definitions

Supplemental Consultation on Spread and Term Adjustments, including Final Parameters thereof, for Fallbacks in Derivatives Referencing EUR LIBOR and EURIBOR, as well as other less widely used IBORs

Executive summary

- ISDA intends to amend its standard documentation to implement fallback reference rates (fallbacks) for certain key IBORs.
- The fallbacks will apply if the relevant IBOR ceases based on defined triggers.[1]
- The fallback rates will be the alternative risk-free rates (RFRs) that have been identified for the relevant IBORs as part of recent global benchmark reform work.
- ISDA previously published a consultation (the July 2018 Consultation[2]) seeking input on the approach for addressing certain technical issues associated with adjustments that will apply to the RFRs if the fallbacks are triggered. This consultation covered GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW, and requested preliminary feedback in respect of USD LIBOR, EUR LIBOR and EURIBOR.
- ISDA subsequently published a supplemental consultation (the May 2019 Consultation[3]) seeking further input on the approach for addressing certain technical issues associated with adjustments that will apply to the RFRs if the fallbacks for USD LIBOR, CDOR or HIBOR are triggered. The May 2019 Consultation also sought feedback on certain aspects of fallbacks for derivatives referencing SOR.

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2020 Consultation on How to Implement Pre-Cessation Fallbacks in Derivatives

Given additional information in the market since ISDA's 2019 consultation on pre-cessation issues for LIBOR derivatives, ISDA is consulting again on whether to add a pre-cessation trigger ('pre-cessation fallback provisions') to the permanent cessation fallbacks that it is implementing for LIBOR in its standard documentation.[1]

Responses are due March 25, 2020. This deadline will not be extended.

Background

Pre-Cessation Fallback Provisions

In a March 2019 letter to ISDA, the Financial Stability Board Official Sector Steering Group (FSB OSSG) co-chairs asked that ISDA consult on determining the need for a potential pre-cessation trigger for fallbacks that would take effect if the UK Financial Conduct Authority (UK FCA) found that LIBOR 'is no longer capable of being representative' or is 'non-representative'. In response to this request, ISDA issued a consultation on May 16, 2019, which is available at:

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Target Timeline for Fallback Implementation

May 2020	May 2020	May - June 2020	June 2020	July 2020	November 2020
Monthly test data published	Final report on 2020 consultation	Business review letter request sent to DOJ	Indicative fallback rates	Amendments to 2006 ISDA definitions	Amendments effective
Bloomberg	ISDA Safe, Efficient Markets	Department of Justice	Bloomberg	ISDA Safe, Efficient Markets	ISDA Safe, Efficient Markets

Cessation and Pre-Cessation Triggers and Adjustment Spreads

The initial results indicate a significant majority of respondents are in favor of including both pre-cessation and permanent cessation fallbacks as standard language in the amended 2006 ISDA Definitions for LIBOR and in a single protocol for including the updated definitions in legacy trades.

8. 91% of the market participant respondents to the 2020 Pre-cessation Consultation (126 out of 138 respondents) answered "Yes" to the Consultation question. Some "Yes" respondents chose to provide additional explanation for their responses. A key reason cited by several of these respondents is the need for consistency across asset classes (most often discussed as consistency between cash and derivative markets by respondents) and between cleared and non-cleared derivative markets. These respondents noted that the inclusion of a pre-cessation trigger for OTC derivative contracts would be in alignment with what is happening in the cash markets, as well as with the arrangements expected to apply to cleared derivatives like swaps. A number of other market participants cited general support for the Consultation, noting that it would be challenging to use non-representative benchmarks.

6: How can I adopt the new fallbacks?

ISDA will publish a supplement amending the 2006 ISDA Definitions to incorporate the new fallbacks. These changes will automatically apply to cleared and non-cleared derivatives referencing the 2006 ISDA Definitions that are executed on or after the date the supplement comes into effect. A protocol will also be published that will enable market participants to choose to incorporate the revisions into their legacy non-cleared derivatives trades with counterparties that also opt to adhere to the protocol. Parties could also agree to incorporate the new fallbacks by bilaterally amending their legacy non-cleared contracts. Clearing houses have indicated they will use the powers in their rule books to implement the fallbacks in all of their legacy cleared derivatives transactions as of the effective date of the updates

Adjustment Spreads

4. In response to Question No. 1, an overwhelming majority of respondents (more than 90%) indicated that they would prefer an implementation based on the compounded setting in arrears rate approach with a backward-shift adjustment and a spread adjustment based on a historical median over a five-year lookback period for fallbacks in derivatives referencing EUR LIBOR and EURIBOR. Only four out of 57 respondents answered "No" to Question No. 1. To

5. With regard to Question No. 3, a majority (58%) of respondents affirmatively noted that they would be able to transact using definitions for EUR LIBOR and EURIBOR that incorporate fallbacks based on the compounded setting in arrears rate approach with a backward-shift adjustment and a spread adjustment based on a historical median over a five-year lookback period. Another 30% of respondents were unresponsive or did not answer to Question No. 3.

The new ISDA Documents

- ISDA Benchmark-Supplement
  - Published on September 19, 2018
  - Applies to all benchmarks (rates, indices, etc.) but on a supplemental basis
- New ISDA RFR trading conventions
  - Published supplements to the ISDA 2006 definitions for USD-SOFR-Compound (no. 56), GBP-SONIA Compound (no. 55), EUR-EuroSTR-Compound (no. 59), SGD-SORA-Compound (no. 62) Floating Rate Options and others
  - Published supplement to the ISDA 2006 definitions for revised EONIA Floating Rate Options (no. 60)
  - These supplements include fallbacks for screen rate disruptions and fallbacks for cessation events (no pre-cessation triggers at this stage)

The new ISDA Documents

- New ISDA 2020 Definitions (publication anticipated in Q4 of 2020): Modernisation and revision of the 2006 Definitions and consolidation with all 65 supplements; Will include inter alia:
  - The new standards for RFRs as well as cessation event triggers and consequences
  - Will include updated fallbacks for existing LIBORs and EURIBOR, including cessation event triggers and consequences
  - Calculation Agent related changes
- ISDA 2020 IBOR Fallback Protocol or Bilateral Adoption Agreements
  - Amending non-cleared legacy transactions under a wide scope of master agreements (excluding German law master agreements)
  - Publication anticipated in July 2020; the amendments to the 2006 Definitions would become effective four months later, in November 2020
  - New trades post effective date that reference the Definitions would automatically incorporate the revised definitions

The new ISDA Documents

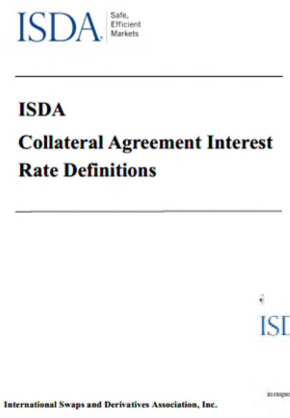
- IBOR Supplement to the ISDA 2006 Definitions
  - Will include updated fallbacks for existing LIBORs and EURIBOR, including cessation event triggers and consequences
- ISDA EONIA Bilateral Amendment Agreement (relating to the replacement of EONIA in Floating Rate Options, CSA, etc.)
- Certain FAQ and other informative documents and videos available. For example the published EURIBOR FAQs by ISDA dated September 10, 2019

Update IBOR / EURIBOR Fallbacks shown on EUR-EURIBOR-Reuters as an Example

- Definition of EUR-EURIBOR-Reuters (unchanged)
- EUR-EURIBOR-Reuters no index cessation fallbacks
  - Alternative source to be used if no screen rate is published (administrator itself or alternative authorized distributor) otherwise
  - Determination by Calculation Agent of a commercially reasonable alternative to EURIBOR recommended by administrator or supervisor or if not available based on own determination taking into account CCPs or futures exchanges
- EUR-EURIBOR-Reuters index cessation fallbacks
  - Reference to "Fallback EuroSTR"
  - Fallbacks in case of non index cessation disruptions of "EuroSTR"
  - Fallbacks in case of a cessation of "Fallback EuroSTR"

Collateral Support Adjustments

- CSAs and CSDs make reference to certain reference rates to determine interest on cash collateral
- ISDA published the new definition booklet „ISDA Collateral Agreement Interest Rate Definitions“ (new version 2.0 with SOFR planned) that can be used in CSAs/CSDs going forward
- The ISDA protocol will also cover most of the CSAs, CSDs and other credit support documents (but not the German *Besicherungsanhänge*)
- If no ISDA protocol adherence is indicated or possible, bilateral amendments are required to update collateral documentation, e.g.
  - ISDA EONIA Bilateral Amendment Agreement (published)
  - ISDA SOFR CSA Amendment Agreement (in draft form)



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ISDA
Collateral Agreement Interest
Rate Definitions

International Swaps and Derivatives Association, Inc.

ISDA

International Swaps and Derivatives Association, Inc.

AMENDMENT

Transition under German Derivatives Documentation

- German law master agreements:
  - DRV: *Deutscher Rahmenvertrag für Finanztermingeschäfte* (uncleared OTC, new 2018 bilingual version available)
  - CRV: *Deutsche Clearing Rahmenvereinbarung* (cleared OTC, new 2019 bilingual version available)
  - *Deutscher Rahmenvertrag für Wertpapierdarlehen* (Securities Lending)
  - *Deutscher Rahmenvertrag für Wertpapierpensionsgeschäfte* (Repo)
- Similar documentation style
- No general protocol solution available for DRV Documentation

Transition under German Derivatives Documentation

- DRV 2018 provides for a general benchmark replacement clause relating to a “floating interest rate, exchange rate, price or other calculation basis“ in the event of a disruption.
  - No pre-cessation trigger
- EONIA to ESTR “no material change“ declaratory provision (for inclusion in the relevant master agreement)
- Bilateral EONIA replacement agreement for DRV/Repo and SecLending Master Agreements
- Work in Progress: IBOR transition agreement

Anna Pinedo

Equity Derivatives in the current Market Environment

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Equity Derivatives

- During recent periods, we have seen increased activity involving:
  - At the market offering programs with equity forwards
  - Stake building transactions
  - Convertible note issuances with related antidilutive transactions, including call spreads or call/warrant structures
  - In select cases, stock repurchase transactions

ATMs with Equity Forwards

Issuer Equity Derivatives

- Through an equity derivatives transaction, an issuer can tailor a transaction in its own securities to meet individual accounting, tax, and other objectives
- There is a broad range of equity derivatives transactions, including:
  - Issuer put options
  - Forward share repurchases
  - Accelerated share repurchases
  - Collared accelerated share repurchases
- Often an issuance of securities for capital-raising purposes, such as the issuance of a convertible note, may be paired with a repurchase (direct or indirect) in order to reduce the dilutive effect of the convertible issuance

At the Market Offering

- An At the Market ("ATM") Offering is an offering of securities into an existing trading market at publicly available bid prices, which is made pursuant to a registration statement filed with the US Securities and Exchange Commission
- An ATM is commonly referred to as "equity distribution" or "equity dribble out" program
- Shares are "dribbled out" to the market over a period of time at prices based on the market price of the securities
- Generally, these sales do not involve special selling efforts

At the Market Offering with a Forward

- Incorporating an equity forward into an ATM program has gained popularity; approximately one-third of ATMs include a forward component
- The offer of the shares pursuant to the forward will be registered with the U.S. Securities and Exchange Commission
- From the perspective of the forward sale, it should qualify for the exclusion from the "swap" definition available for:
  - "any agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a contingent basis that is subject to the Securities Act of 1933 (15 U.S.C. 77a et seq.) and the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), unless the agreement, contract, or transaction predicates the purchase or sale on the occurrence of a bona fide contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract, or transaction" CEA 1a(47)(B)(vi)"

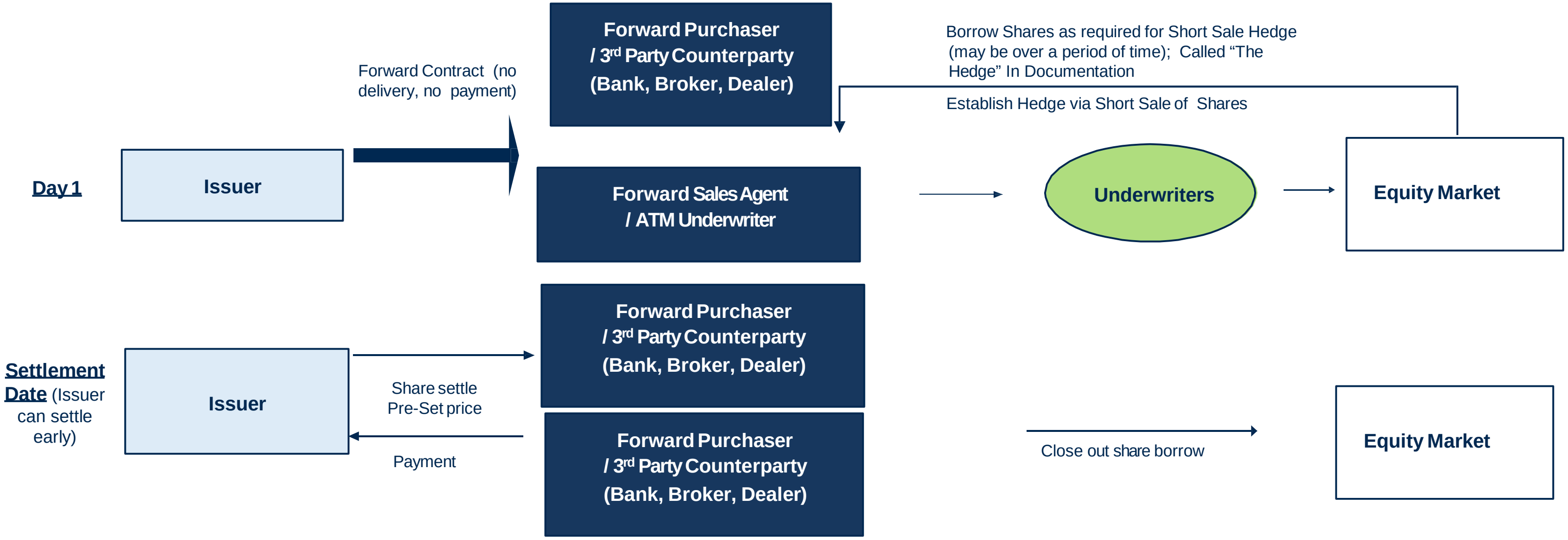
At the Market Offering with a Forward

- Terms in the FSA that depend on interest rates and stock borrow fees, to the extent they reflect the purchaser’s net carrying cost for its short position should not upset this conclusion. This is based on analogy to guidance in the Product Definitions re the funding leg of total return swaps, and on the fact that these dependencies are not severable

At the Market Offering with a Forward

- A FSA might also qualify for the capital-raising exclusion:
  - "any agreement, contract, or transaction that is –
  - (I) based on a security; and
  - (II) entered into directly or through an underwriter (as defined in section 2(a)(11) of the Securities Act of 1933 (15 U.S.C. 77b(a)(11)) [5] by the issuer of such security for the purposes of raising capital, unless the agreement, contract, or transaction is entered into to manage a risk associated with capital raising," CEA 1a(47)(B)(viii)."
- If the FSA qualifies for one of these exclusions, then it would not be a swap or a security-based swap

Forward-Sales Agent Structure



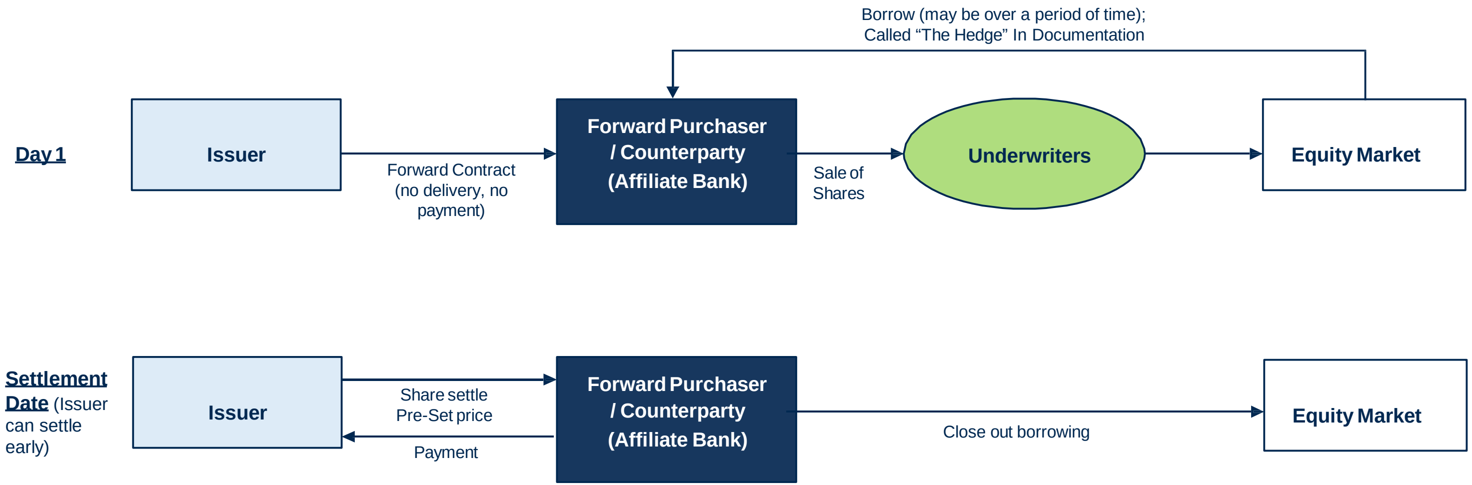
Settlement can be:

1. Physical – delivery at pre-set price
2. Cash – pre-set price vs. market price
3. Net share – like cash settlement but payment in shares

Risks:

1. Borrow shares / delta one hedge inability to maintain till maturity
2. Counterparty risk if issuer goes bankrupt
3. No dynamic hedging

Forward – Forward Purchaser Structure



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Stake Building Transactions

Stake-Building Transactions

- When considering an acquisition target some potential acquirors endeavor to build stake in the target without triggering the filing requirements under the U.S. Hart-Scott-Rodino Act (HSR Act)
- Combining outright share purchases with forwards, options and collars has been one technique for achieving this objective
- Acquiror has dual objectives:
  - Keep holdings below percentages that would trigger reporting under U.S. securities law, especially 5% threshold under Section 13 of the 1934 Act
  - Keep aggregate purchase price below filing threshold under HSR Act, which is currently $80.8 million (this amount increases annually)
- One example is to use a call spread with a zero lower strike to create a synthetic forward position in the target shares

Stake-Building Transactions

- Acquiror might first make outright purchases up to the $94 million threshold (assuming this is below the 5% Section 13 level)
- Then acquiror could execute a derivative giving it synthetic forward exposure to additional shares, but also keeping the combined percentage of shares owned outright and shares that can be acquired under the derivative below 5% Section 13 level
- In addition, so as not to breach the HSR threshold derivative documentation will include an HSR specific provision that prohibits the acquiror from electing physical settlement unless HSR filing requirements as satisfied
  - Otherwise, acquiror must cash settle which would not count against the HSR threshold

Stake-Building Transactions

- Applicability of HSR Act has a jurisdictional basis
  - HSR will apply if the target entity has sufficient sales or revenue into the US
  - It does not matter where the target's equity shares are traded
- There are other exemptions from required reporting under HSR Act:
  - Acquisition of less than a controlling interest in a non-US issuer is generally not reportable
  - Acquisition of less than 50% of a unincorporated entity (e.g., partnership, LLP, LLC) is generally not reportable
  - "Investment only" exemption for (a) purely passive investments that (b) result in holding less than 10% voting securities
- Determination of HSR Act applicability requires careful and thorough factual analysis

Section 13 and Section 16

- Large transactions (exceeding 5%, 10% and greater) will require analysis of
  - possible application of Section 13 of the 1934 Act to 5% stakes
  - possible application of Section 16 of the 1934 Act to 10% stakes, and
  - possible deemed affiliate status
- 5% holders need to file a Schedule 13D or 13G (short form disclosure schedule for certain institutional and passive investors)
- 10% holders need to file Section 16 reports and are subject to short-swing profits for purchases and sales occurring within six months of each other (certain exemptions from Section 16 are available for categories of institutional investors)
  - Foreign private issuers are exempt
- Note that the inability to rely on the HSR Act exemption alone would not preclude a 5% holder from filing a Schedule 13G. Determination based on facts and circumstances.

What is Insider Trading?

- Buying or selling publicly traded equity or debt securities while aware of material nonpublic information acquired through a relationship of trust or confidence with scienter (e.g., knowledge of wrongdoing), personal benefit (monetary or intangible)

What is Material Nonpublic Information?

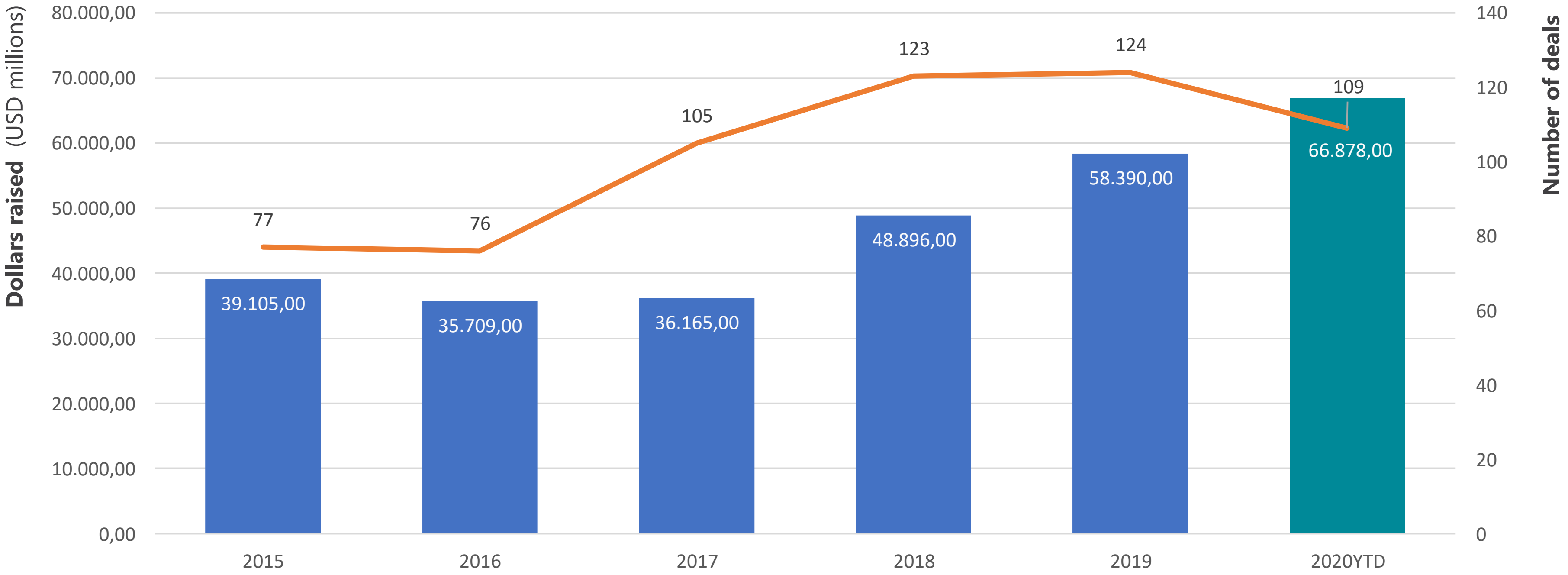
- The test for materiality:

  > "A substantial likelihood that the information would be considered significant to a reasonable investor in making an investment decision regarding the purchase or sale of a company's securities."

- In an SEC enforcement case, criminal proceeding or private litigation, the materiality of information is always judged with 20/20 hindsight
- Nonpublic information is information that:
  - has not previously been **broadly disseminated** to the **general public**; and
  - is **not otherwise available** to the general public

Convertible Debt

Convertible Debt – Market Overview



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Convertible Debt – Benefits & Considerations

- What are the benefits to an issuer of offering and selling a convert?
  - Tax-deductible interest expense decreases the issuer's after-tax cost of capital
  - Ability to issue common stock at a premium to current market (conversion settled in stock)
  - Option to minimize share dilution via net share settlement feature (cash or stock settlement)
  - Flexible call structures can reflect the issuer's view on its own stock
  - No financial covenants
  - Appeals to a broad investor base
- Considerations
  - Treated as debt on the issuer's balance sheet
  - Periodic cash coupon payments (conversion settlement in stock only)
  - Periodic non-cash interest expense (conversion settlement in cash or stock)
  - No "equity credit" given by rating agencies
  - Share dilution, if converted (FAS-128) or treasury stock method (with cash settled instruments)
  - Obligation to repay principal, if not converted
  - No increase in the public share float prior to conversion ("plain vanilla")

Settlement Considerations for Convertible Debt

- Convertible bonds can be settled in a number of different ways:
  - "Physical settlement": Issuer delivers shares upon conversion
  - "Net Share Settlement": Issuer pays part in cash and delivers shares for the in-the-money amount of the conversion option
  - "Cash or stock in any combination": Issuer pays cash or delivers stock in any combination at its discretion
  - "Cash settlement": Issuer pays cash equal to conversion value in all scenarios
  - Settlement method generally does not impact convertible pricing

Current US GAAP Accounting Treatment Impact

Settlement Method	Balance Sheet	Interest Expense	EPS Dilution
Physical (Stock) Settlement	Debt	Convertible Coupon	If-Converted Method
Net Share Settlement	Debt Plus Option	Straight Debt Cost	Treasury Stock Method
Cash or Stock in Any Combination	Debt Plus Option	Straight Debt Cost	If-Converted Method
Cash Settlement (1)	Debt Plus Option	Straight Debt Cost MTM of Option Value (1)	None from Convertible Treasury Stock Method from Warrant Strike (1)

Note 1. Typically combined with cash settled bond hedge to offset mark to market impact and separately sold net share settled high strike warrant.

Settlement Considerations for Convertible Debt

Evolutionary — Transformational

Low Execution Risk — High Execution Risk

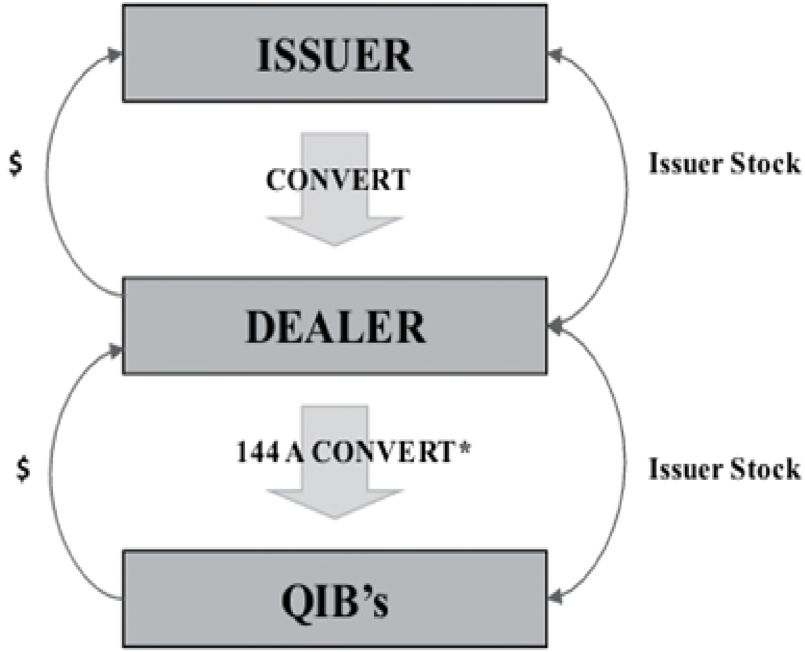
	Open Market	Prepaid/Accelerated Share Repurchase	Tender Offer
Advantages	• Continued stock support • "At-market" repurchase • Maximum Flexibility • Lowest cost • Can be executed in a 10b5-1 program or opportunistically	• Optional upfront share count reduction • "At-market" repurchase • Potential tax efficiencies • Strong signal • Economic Protection/discount available	• Speed of repurchase completion near current valuation • Strongest signal • Liquidity event for investors • Rapid share count reduction
Disadvantages	• Limited by daily volume • Exposed to market price over time • Share count reduction over time • Weaker signal • No guarantee of completion	• Exposed to market price over time • Fully funded upfront • Commits Issuer to complete repurchases	• Requires premium to current price • Investors determine success of tender • Higher transaction costs • No ongoing stick support
Mechanics	• Issuer purchases shares in the open market over time • Can buy back stock during blackout period via 10b5-1	• Bank sells the block to Issuer upfront • Bank repurchases stock in the open market over time • True up payment and/or additional shares delivered at completion of cover period	• Issuer specifies a number of shares to be repurchased within a defined price or at specific fixed price • Shareholders decide whether they would like to participate in the offer • Tender offer open for a minimum of 20 days
Documentation	• Short form appointment letter • No public documentation	• Master confirmation • No public documentation	• Schedule tender offer filed with SEC
Application	• Desire to maintain flexibility including ability to stop	• Minimum value of shares Issuer desires to purchase	• Repurchase large block of stock in a short period of time

Basic Happy Meal

Issuer is an Exchange Act filer

*Convert sold in a private placement. Convert has at least 10% premium (to qualify as a "different security")

QIBs sell issuer stock to Dealer because QIBs are selling short to hedge the embedded call option that QIBs have purchased indirectly by purchasing the 144A convert



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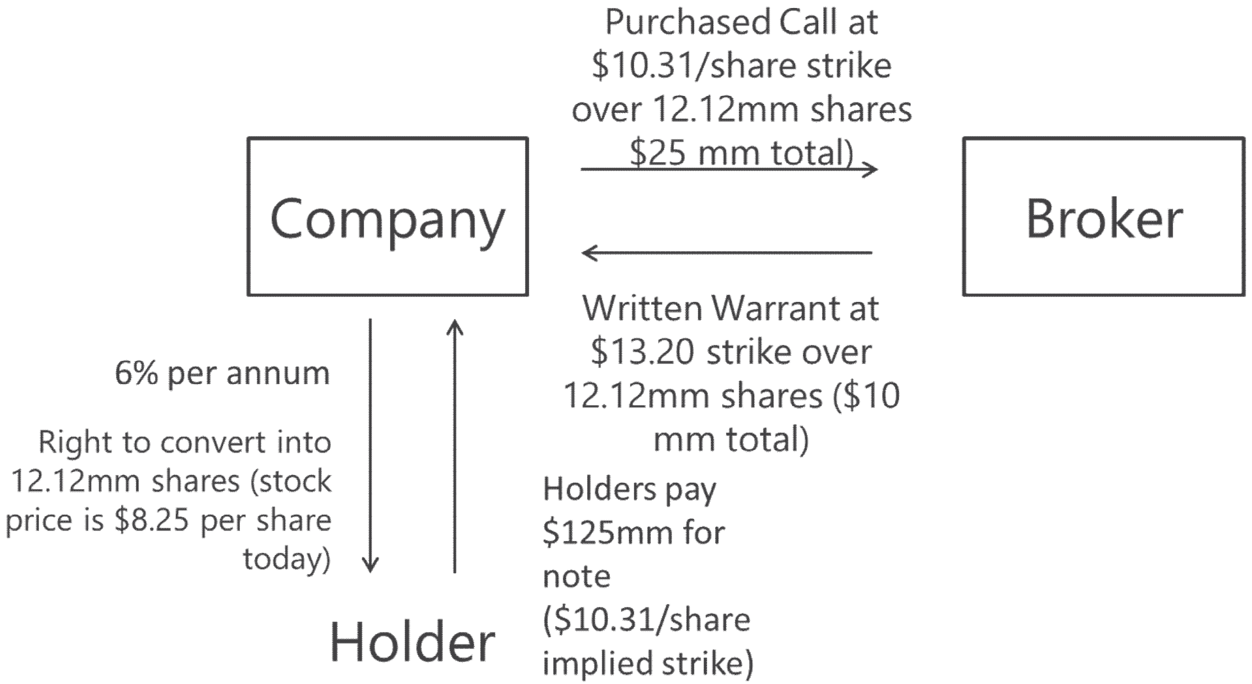
Convertible Note Hedge plus Warrant (Call Spread) Overview

- What is it?
  - A distinct transaction that serves to increase the conversion premium synthetically on a convertible transaction
- How does it work?
  - A call spread is the purchase of a call option struck at the conversion price of the convertible security (lower strike price) and the simultaneous sale of a warrant (call option) struck at a higher exercise price (upper strike price)
  - The number of shares underlying both options is the same amount of shares that underlay the convertible security
  - This transaction enables the company to eliminate EPS dilution economically resulting from the conversion of the convertible up to the upper strike price
- What is the economic cost?
  - The company pays for the call options and receives payment from the sale of the warrants
    - The difference between the purchase of the calls and the sale of the warrants is the net cost of the call spread to the company

Convertible Note Hedge plus Warrant (Call Spread) Overview

  - This net cost is treated as a reduction to shareholder equity
  - However, the issuer is generally able to deduct the full amount of the purchase price of the call option for tax purposes
  - The call spread is worth zero at maturity if the common stock does not trade above the conversion price of the bond
- GAAP diluted share count
  - For GAAP purposes, the diluted share count is determined without consideration to the derivative transaction

Convertible Bond Call Spread



Repurchase Transactions

What is an ASR?

- An accelerated share repurchase, or ASR, is a structured, privately negotiated transaction, usually documented as a "forward" contract, in which a dealer agrees to sell a pre-defined amount of stock to a company at a price per share that is based on the VWAP during the relevant period
- A dealer acts as the "seller" of company shares in an ASR, and the company acts as the "purchaser" in buying back its own shares
- Numerous dealers have engaged in ASRs with their corporate clients
- Although ASRs are now commoditized to a significant extent, they do entail legal considerations that require review by counsel

ASR – During Trade

- Over life of trade dealer covers short by purchasing shares of the issuer in the open market
- Purchase period will have a fixed starting and ending point, though dealer will have right, upon notice to issuer, to cut short the purchase period
- An average price (A) will be determined for the purchase period
  - Typically will be based on 10b-18 VWAP for every trading day during the purchase period, minus an agreed discount or price adjustment

ASR – At Maturity

- If average price (A) is below the initial price (B), then the dealer will owe the final settlement to the issuer:
  - In general, ASRs will provide that the dealer will make physical settlement by delivering extra shares to the issuer:
  - The number of extra shares will equal:
    - The amount the issuer paid at trade inception divided by A minus the number of shares the dealer sold to the issuer at trade inception
- If the average price (A) is above the initial price (B), issuer will owe the final settlement to the dealer
  - The issuer will have the election to make settlement either in cash or by delivery of additional shares
  - However, when settlement is due from the issuer, more complex settlement mechanisms are triggered to address various securities law issues raised by the prospect of an issuer issuing shares

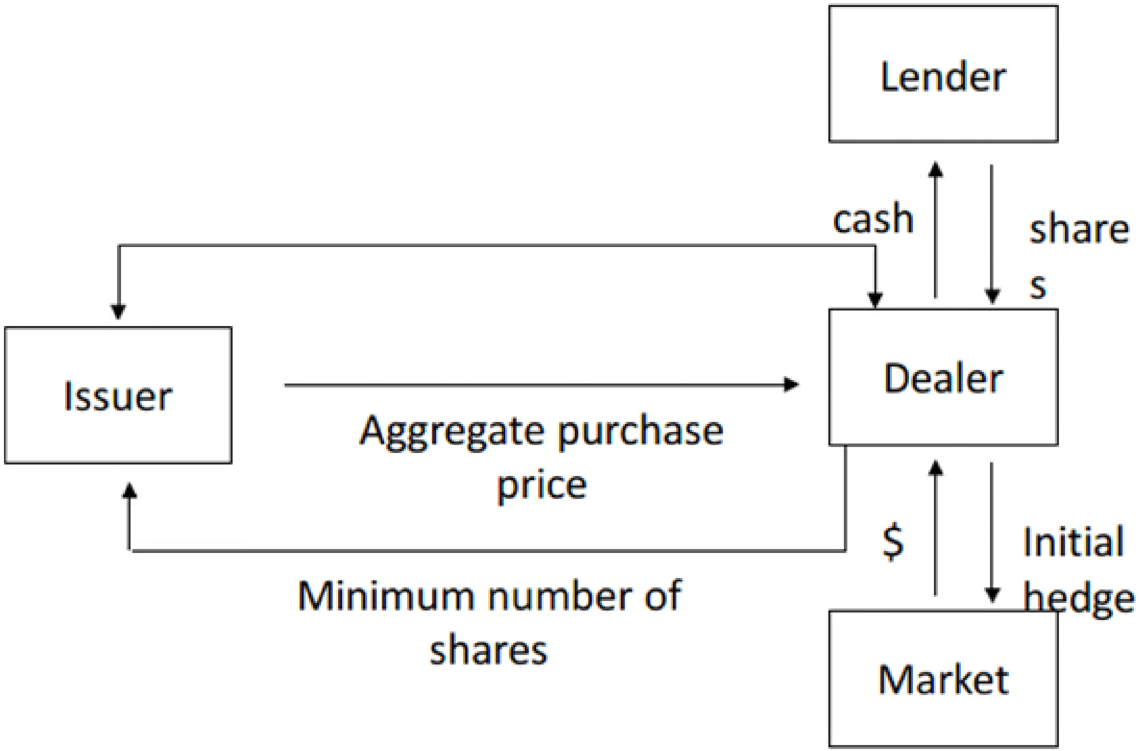
Collared ASR

- In many respects similar to basic ASR:
  - Issuer executes an accelerated share repurchase program to repurchase shares at a discount to the average 10b-18 VWAP over the term
  - Issuer spends a fixed dollar amount to repurchase stock
    - Total number of shares repurchased equals:
      - Upfront payment divided by [Average Daily 10b-18 VWAP-discount], subject to a minimum and maximum number of shares
      - Total repurchase cost fixed upfront
      - Shares repurchased at a discount to average daily 10b-18 VWAP
- However, collar protects issuer if the stock price appreciates and allows issuer to participate in price depreciation up to the minimum repurchase price

Collared Forward Share Repurchase

- Issuer pays a fixed aggregate purchase price
- Dealer delivers a variable number of shares determined on a per-share purchase price equal to the average price which is subject to a collar
  - Cap on average price equals strike price of a call option purchased by the issuer on its own stock
  - Floor on average price represents strike price of a put option purchased by the dealer on the stock
- Permits issuer to retire the minimum number of shares at inception of trade (boosts EPS)
- Lets issuer repurchase shares at average price over term minimizing volatility

Collared Forward – At Inception



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Collared Forward Share Repurchase

- Parties agree on aggregate price, floor on per-share price and cap on per-share price
- Issuer pays aggregate price
- Dealer establishes initial hedge for collar by buying shares over a period of days
- After initial hedge period, dealer delivers minimum number of shares (divide cap price per share into aggregate purchase price)
- At maturity, total number of shares to be purchased is determined by dividing average price over term of trade into aggregate price
- If total number of shares is greater than the minimum number delivered initially, dealer delivers additional shares (but never more than the maximum)

Section 5

- Dealer's initial sale of shares to the issuer not subject to registration
- Dealer's delivery of stock in stock settlement not subject to registration
- If ASR allows issuer to deliver shares at maturity to dealer – the shares will be "restricted securities" in the dealer's hands
  - Need resale provisions
- Attribution issues:
  - Can dealer's market purchases be attributed back to the issuer and require that the dealer's short covering be subject to Section 5 registration requirements?
  - Can dealer's hedging be attributed to the issuer?
  - Addressed by de-linking transactions so that the issuer doesn't share in dealer's losses or benefit from dealer's gains from hedging

Section 9 and Section 10 of the Exchange Act

- Section 9(a)(2) – cannot effect any transaction or series of transactions in any security that creates actual or apparent active trading in that security, or raises or depresses its price, for the purpose of inducing the purchase or sale of the security
- Section 10(b) – cannot employ any manipulative or deceptive device or contrivance in connection with the purchase or sale of a security
- Rule 10b-5 – cannot employ any device, scheme or artifice to defraud, make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading, or engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security

10b-18 Safe Harbor

- 10b-18 provides a non-exclusive safe harbor from liability under Section 9(a)(2) and 10(b) and Rule 10b-5
- Though 10b-18 does not directly apply to derivative transactions, most market participants nonetheless rely on 10b-18 by analogy
- SEC Division of Market Regulation: Answers to Frequently Asked Questions Concerning Rule 10b-18 (as modified, November 17, 2004)
  - Question 13: is the Rule 10b-18 safe harbor available for an issuer and the broker-dealer who engage in an accelerated share repurchase plan or use a forward contract to repurchase the issuer’s stock?

10b-18 Safe Harbor

- Answer: Accelerated share repurchase plans and forward contracts are private (off-market) transactions. Therefore, they are not eligible for the Rule 10b-18 safe harbor, which applies only to open market purchases. Moreover, the Rule 10b-18 safe harbor also is not available for the broker’s covering transactions, as these transactions are not agency or riskless principal trades effected on behalf of the issuer.

- The conditions of 10b-18 include:
  - A single broker or dealer making purchases/sales on a single day
  - Trading window
  - Price restrictions
  - Volume thresholds

Rule 10b5-1

- 10b5-1 establishes an affirmative defense to claims that a person has made a purchase or sale on the basis of material nonpublic information
- An issuer also may rely on 10b5-1 for itself
  - Issuer should represent that it is not in possession of material nonpublic information when entering into the ASR/Collared ASR
  - ASR/Collared ASR will not permit the issuer to influence the bank's purchases or to share material nonpublic information with the dealer
  - Issuer will not be able to change terms, except when it can represent that it is not in possession of material non-public information ("MNPI")
  - Program may establish black-outs (most arrangements then extend the term of the ASR/Collared ASR for each black-out day)
- If a transaction gives an issuer any option (such as whether to make cash or physical settlement), the issuer may be required to repeat its representation that it does not possess MNPI if it makes such election

Chris Arnold, Ed Parker, Patrick Scholl

EMIR Update

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EMIR Update

- **EMIR Refit** (Reg (EU) 2019/834) and **EMIR 2.2** (Reg (EU) 2019/2099)
- Recent developments (I/II)
  - June 2020: Decision of ESMA, in view of the effects of the ongoing COVID-19 pandemic on stakeholders and market participants, to extend the response date for the consultation on the technical standards on reporting, data quality, data access and registration of Trade Repositories under EMIR REFIT to 3 July 2020.
  - June 2020: ESMA published Final Report on FRANDT Commercial Terms for Clearing Services (2 June 2020 | ESMA70-151-3107)
  - June 2020: ESMA published three draft Delegated Acts on (i) compliance of non-EU clearing houses, (ii) determining the systemic risk of non-EU clearing houses (tiering criteria) and (iii) fees to be charged to non-EU clearing houses for consultation (Ref. Ares(2020)3026676 - 11/06/2020, Ref. Ares(2020)3125960 - 16/06/2020 and Ref. Ares(2020)3026705 - 11/06/2020)
  - May 2020: ESMA published updates to EMIR Q&A (28 May 2020| ESMA70-1861941480-52) – see following slides re EMIR Refit and changes to the reporting regime for NFC-
  - May 2020: Joint RTS of ESAs on Amendments to the Bilateral Margin Requirements under EMIR in Response to the COVID-19 Outbreak (Introduction of Initial Margin Phase 5 and 6 and their delay, delay of in scope Single Stock Options, etc.)

EMIR Update

- Recent developments (II/II)
  - December 2019: Commission implementing decision (EU) 2019/2211 amending Implementing Decision (EU) 2018/2031 determining, for a limited period of time, that the regulatory framework applicable to central counterparties in the United Kingdom of Great Britain and Northern Ireland is equivalent, in accordance with Regulation (EU) No 648/2012
  - December 2019: Commission delegated regulation (EU) 2020/448 amending delegated regulation (EU) 2016/2251 as regards the specification of the treatment of OTC derivatives in connection with certain simple, transparent and standardised securitisations for hedging purposes
  - December 2019: Commission delegated regulation (EU) 2020/447 supplementing Regulation (EU) No 648/2012 with regard to regulatory technical standards on the specification of criteria for establishing the arrangements to adequately mitigate counterparty credit risk associated with covered bonds and securitisations, and amending delegated regulations (EU) 2015/2205 and (EU) 2016/1178

EMIR Refit – New Reporting Regime for NFC-

- Changes in the reporting regime - Art. 9 para. 1a EMIR
- Since 18 June 2020, NFC- are generally no longer required to report their OTC derivative contracts
- <u>But</u>: Their financial counterparties (FC) shall be solely responsible, and legally liable, for reporting on behalf of both counterparties
- "Financial counterparties shall be solely responsible, and legally liable, for reporting on behalf of both counterparties, the details of OTC derivative contracts concluded with a non-financial counterparty that does not meet the conditions referred to in the second subparagraph of Article 10(1) **["NFC-"]**, as well as for ensuring the correctness of the details reported.

  To ensure that the financial counterparty has all the data it needs to fulfil the reporting obligation, the non-financial counterparty shall provide the financial counterparty with the details of the OTC derivative contracts concluded between them, which the financial counterparty cannot be reasonably expected to possess. The non- financial counterparty shall be responsible for ensuring that those details are correct.

  Notwithstanding the first subparagraph, non-financial counterparties who have already invested in a reporting system may decide to report the details of their OTC derivative contracts with financial counterparties to a trade repository. In that case, the non-financial counterparties shall inform the financial counterparties [... and] shall be responsible, and legally liable, for reporting those details and for ensuring their correctness."

Update on EMIR: Recent Reporting Changes

- For trades entered into from 18 June 2020 (1 year anniversary of EMIR REFIT):
  - AIFMs responsible for reporting OTC derivatives of their EU AIFs
    - AIF still responsible for ETD trades
    - AIF may delegate reporting but remains responsible
  - FCs responsible for reporting OTC derivatives for NFC- (including NFC- SPVs)
    - NFC- still responsible for OTC trades with non-EU FCs and ETD trades
    - ESMA Q&A TR Question 54 (updated 28 May) addresses relationship between FC and NFC-
- ESMA March 2020 Consultation (response deadline extended to 3 July 2020)
  - Draft RTS/ITS on: Reporting, data quality, data access and registration of TRs

Update on EMIR: Recent Reporting Changes

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EMIR Refit – New Reporting Regime for NFC-

- Consequences of the new reporting regime:
  - Need for change of the existing delegation agreements as there cannot be a delegation any longer.
  - In order to comply with the own obligation to report details of OTC derivative transactions on behalf of both counterparties, FCs may also want to establish detailed rules which information needs to be provided to them by NFC- and the consequences of any failure to do so.
  - Guidance on which of the reportable details specified in the Annex to the Regulation (EU) 2017/104 should be provided by the NFC- given in new ESMA EMIR Q&A, TR Answer 54 (28 May 2020 | ESMA70-1861941480-52):

    → (i. Field 1.2 Reporting counterparty ID, ii. Field 1.6 Corporate sector of the counterparty, iii. Field 1.7 Nature of the counterparty, iv. Field 1.8 Broker ID (if unknown by FC), v. Field 1.10 Clearing Member (if unknown by FC), vi. Field 1.11 Type of ID of the beneficiary (if beneficiary is different from the NFC-), vii. Field 1.12 Beneficiary ID (if beneficiary is different from the NFC-), viii. Field 1.13 Trading capacity, ix. Field 1.15 Directly linked to commercial activity or treasury financing, x. Field 1.16 Clearing threshold.
  - Clients (also NFC-) report about significant paperwork in view of the benefits for NFC-.

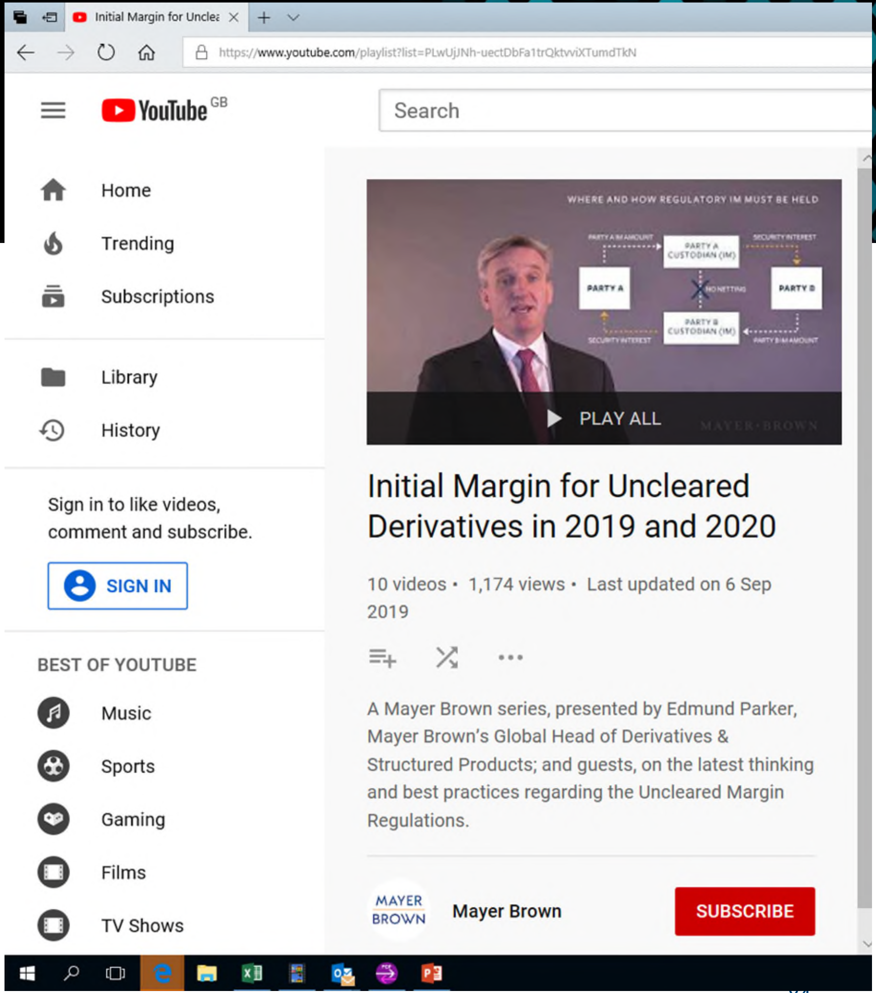
EMIR Refit – Documentation

- Master Regulatory Reporting Agreement ("MRRA") published by joint associations in December 2019 to facilitate both EMIR and SFTR reporting
- In Germany:
  - New EMIR Addendum has been published in 2019
  - New drafting guidelines for a reporting arrangement between FC and NFC- has been developed to replace existing delegation reporting agreements

Update on EMIR: Other Developments

- Three draft EMIR 2.2 Delegated Regulation consultations (deadline 9 July):
  - Fees charged by ESMA to third-country CCPs
  - Identifying systemically important third-country CCPs
  - Comparable compliance assessment of third-country CCPs
- Joint ISDA/EBF/FIA letter on intragroup clearing exemption (due to expire on December 2020) requesting:
  - Adoption of equivalence decisions for all jurisdictions with clearing mandate
  - 3 year extension for intragroup transactions with non-EU affiliates in jurisdictions where no equivalence decision

Initial Margin


Initial Margin for Unclea
https://www.youtube.com/playlist?list=PLwUjJNh-uectDbFa1trQktvviXTumdTkN
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PARTY B
PARTY A CUSTODIAN (IM)
PARTY B CUSTODIAN (IM)
NO NETTING
SECURITY INTEREST
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Initial Margin for Uncleared Derivatives in 2019 and 2020
10 videos • 1,174 views • Last updated on 6 Sep 2019
A Mayer Brown series, presented by Edmund Parker, Mayer Brown's Global Head of Derivatives & Structured Products; and guests, on the latest thinking and best practices regarding the Uncleared Margin Regulations.
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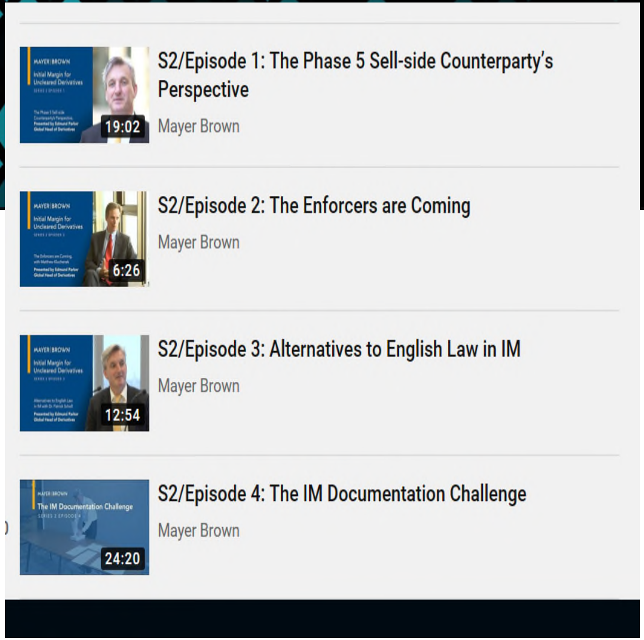
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S2/Episode 1: The Phase 5 Sell-side Counterparty's Perspective
Mayer Brown
6:26
S2/Episode 2: The Enforcers are Coming
Mayer Brown
12:54
S2/Episode 3: Alternatives to English Law in IM
Mayer Brown
The IM Documentation Challenge
24:20
S2/Episode 4: The IM Documentation Challenge
Mayer Brown


Initial Margin for Uncleared Derivatives in 2019 and 2020
YouTube GB
A Mayer Brown series, presented by Edmund Parker and guests. Click here for Series 1

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Changes afoot as a Result of Lobbying Efforts

ISDA Safe, Efficient Markets | sifma | sifma asset management group | alfi association of the Luxembourg fund industry

May 17, 2019

Mr Steven MAIJOOR
Chairman, European Securities and Markets Authority
CS 60747
103 rue de Grenelle
75345 Paris Cedex 07, France

Mr José-Manuel CAMPA
Chairman, European Banking Authority
DEFENSE 4 – EUROPLAZA
20 Avenue André Prothin
CS 30154
92927 Paris La Défense CEDEX

Mr Gabriel BERNARDINO
Chairman, European Insurance and Occupational Pensions Authority
Westhafenplatz 1
60327 Frankfurt am Main
Germany

been provided in conjunction with this letter.[6] The data covers 16,340 separate legal counterparties, with 34,680 individual relationships.[7] Based on the current regulatory requirements, we estimate the following impacts for Phase 5 of UMR:

- Over 1,100 newly in-scope counterparties (NISCs), which have over 9,500 new relationships with other counterparties subject to UMR.[8]
- Each of the 9,500 new relationships requires new or amended documentation that must be tested and uploaded into systems.
- Up to 19,000 segregated IM custody accounts must be set up and tested (two per relationship, for the posting and collection of IM).
- Depending on the IM calculation method, between 26-45% of the smallest counterparties, and 69-78% of counterparty relationships, are unlikely to exchange any IM at all, as they fall below a USD 50 million IM exchange threshold (IM exchange threshold).[9] As such, these counterparties will be

IM SEG REQUIREMENTS – CALCULATION OF AANA

Aggregate Average Notional Amount ("AANA") – Calculation requirements are regime-specific (e.g. different scope of products, currencies and measuring periods)

EU AANA

- Average aggregate notional amounts during observation period
- Include all non-cleared derivatives transactions, including intra-group but counting them only once
- Include all entities that consolidate into financial statements

EU Draft RTS

esma European Securities and Markets Authority | EBA European Banking Authority | eiopa European Insurance and Occupational Pensions Authority

Final Report

EMIR RTS on various amendments to the bilateral margin requirements in view of the international framework

19 De

esma European Securities and Markets Authority | EBA European Banking Authority | eiopa European Insurance and Occupational Pensions Authority

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COMMISSION DELEGATED REGULATION (EU) No …/..

amending Delegated Regulation (EU) 2016/2251 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council as regards to the timing of when certain risk management procedures will start to apply for the purpose of the exchange of collateral

of [ ]

(text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories[1], and in particular Article 11(15) thereof,

Whereas:

1. Threshold Issue

2.2 Proposed amendments and clarifications

2.2.1 Clarification of the requirements when below the 50 million initial margin threshold

The ESAs have reviewed the application of the relevant requirements of Commission Delegated Regulation on bilateral margining and are of the view that that clarification can already be taken into account when applying them. Thus, the ESAs consider that there is no need to amend the Delegated Regulation on bilateral margin requirements in order for counterparties below the 50 million initial margin exchange threshold not to be required to have all the relevant operational and legal arrangements in place. No amendment related to this point is thus included in the draft RTS in Annex.

U.S. Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581

J. Christopher Giancarlo
Chairman

April 29, 2019

Hon. Randal K. Quarles,
Vice Chair for Supervision
Federal Reserve Board of Governors
Constitution Ave. & 20th Street, NW
Washington, DC 20551

Dear Randy,

I want to follow up on a recent conversation about "Phase Five" imp
requirements for initial margin on uncleared swaps scheduled for Septemb
("Phase Five Implementation"). As we discussed, the CFTC's Office of Ch
has analyzed market data in light of concerns of many small market partici
be brought into scope in the Phase Five Implementation.[1] CFTC staff has
reviewed additional data from market participants and industry organizations.

Based on the CFTC analysis, I would like to recommend that:

This problem is exacerbated by a significant quirk in the rules: physically-settled FX swaps are included in the calculation of notional amount even though they are exempt from initial margin requirements. An entity doing nothing but $8 billion of physically-settled FX, for example, would have to prepare to exchange initial margin even though its entire portfolio is exempt from margin requirements.

Not surprisingly, then, the prospect of futile preparations and costs have spurred requests for regulatory relief.

One form of relief would be to raise the materia
$8 billion notional to some higher level, say $50 billion
indicates, however, that this change might raise conce
system not intended by the current regulatory structur
with notional amounts between $8 and $50 billion wou
having calculated initial margin amounts greater than

A different form of relief, however, does not ha
clarificatory guidance that entities need not have in pl
exchange initial margin if their calculated bilateral initi
than $50 million.

framework, although the position may be different under relevant implementing laws.

- In the remaining phases of the framework's implementation in 2019 and 2020, initial margin requirements will apply to a large number of entities for the first time, potentially involving documentation, custodial and operational arrangements. The Basel Committee and IOSCO note that the framework does not specify documentation, custodial or operational requirements if the bilateral initial margin amount does not exceed the framework's €50 million initial margin threshold. It is expected, however, that covered entities will act diligently when their exposures approach the threshold to ensure that the relevant arrangements needed are in place if the threshold is exceeded.

The Basel Committee and IOSCO will continue to monitor the effect of meeting the final stage of phase-in, scheduled for 2020.

The Threshold Issue: Dividing Across the Group

Article 29

Threshold based on initial margin amounts

1. By way of derogation from Article 2(2), counterparties may provide in their risk management procedures that initial margin collected is reduced by an amount up to EUR 50 million in the case of points (a) and (b) of this paragraph or EUR 10 million in the case of point (c) where:

(a)neither counterparty belongs to any group;

(b)the counterparties are part of different groups;

(c)both counterparties belong to the same group.

2. Where a counterparty does not collect initial margins in accordance with paragraph 1(b), the risk management procedures referred to in Article 2(1) shall include provisions on monitoring, at group level, whether that threshold is exceeded and provisions for the retention of appropriate records of the group's exposures to each single counterparty in the same group.

3. UCITS authorised in accordance with Directive 2009/65/EC and alternative investment funds managed by alternative investment fund managers authorised or registered in accordance with Directive 2011/61/EU shall be considered distinct entities and treated separately when applying the thresholds referred to in paragraph 1 where the following conditions are met:

(a)the funds are distinct segregated pools of assets for the purposes of the fund's insolvency or bankruptcy;

(b)the segregated pools of assets are not collateralised, guaranteed or otherwise financially supported by other investment funds or their managers.

Article 28

Threshold based on notional amount

1. By way of derogation from Article 2(2), counterparties may provide in their risk management procedures that initial margins are not collected for all new OTC derivative contracts entered into within a calendar year where one of the two counterparties has an aggregate month-end average notional amount of non-centrally cleared OTC derivatives for the months March, April and May of the preceding year of below EUR 8 billion.

The aggregate month-end average notional amount referred to in the first subparagraph shall be calculated at the counterparty level or at the group level where the counterparty belongs to a group.

2. Where a counterparty belongs to a group, the calculation of the group aggregate month-end average notional amount shall include all non-centrally cleared OTC derivative contracts of the group including all intragroup non-centrally cleared OTC derivatives contracts.

For the purposes of the first subparagraph, OTC derivative contracts which are internal transactions shall only be taken into account once.

3. UCITS authorised in accordance with Directive 2009/65/EC and alternative investment funds managed by alternative investment fund managers authorised or registered in accordance with Directive 2011/61/EU of the European Parliament and of the Council (*) shall be considered distinct entities and treated separately when applying the thresholds referred to in paragraph 1 where the following conditions are met:

(a)the funds are distinct segregated pools of assets for the purposes of the fund's insolvency or bankruptcy;

(b)the segregated pools of assets are not collateralised,

(13)While the thresholds should always be calculated at group level, investment funds should be treated as a special case as they can be manage single investment manager and captured single group. However, where the fun

Basel Committee on Banking Supervision

Board of the International Organization of Securities Commissions

Margin requirements for non-centrally cleared derivatives

2(ii) The requirement that the threshold be applied on a consolidated group basis is intended to prevent the proliferation of affiliates and other legal entities within larger entities for the sole purpose of circumventing the margin requirements. The following example describes how the threshold would be applied by an entity that is facing three distinct legal entities within a larger consolidated group.

2(iii) Suppose that a firm engages in separate derivatives transactions, executed under separate legally enforceable netting agreements, with three counterparties, A1, A2, A3. A1, A2 and A3, all belong to the same larger consolidated group such as a bank holding company. Suppose further that the initial margin requirement (as described in Element 3) is €100 million for each of the firm's netting sets with A1, A2 and A3. Then the firm dealing with these three affiliates must collect at least €250 million (250=100+100+100–50) from the consolidated group. Exactly how the firm allocates the €50 million threshold among the three netting sets is subject to agreement between the firm and its counterparties. The firm may not extend a €50 million threshold to each netting set with, A1, A2, A3, so that the total amount of initial margin collected is only €150 million (150=100-50+100-50+100–50).

2(iv) Furthermore, the requirement to apply the threshold on a fully consolidated basis applies to both the counterparty to which the threshold is being extended and the counterparty that is extending the threshold. As a specific example, suppose that in the example above the firm (as referenced above) is itself organised into, say, three subsidiaries F1, F2 and F3 and that each of these subsidiaries engages in non-centrally cleared derivatives transactions with A1, A2 and A3. In this case, the extension of the €50 million threshold by the firm to A1, A2 and A3 is considered across the entirety of the firm, ie F1, F2, and F3, so that all subsidiaries of the firm extend in the aggregate no more than €50 million in an initial margin threshold to all of A1, A2 and A3.

Dividing the Threshold

Phase	AANA Range	Relationships	IM ≤ EUR50M	IM > EUR50M
Phase Five	€50bn<AANA≤€750bn	3,616	2,125 to 2,595 (59 to 72%)	1,021 to 1,491 (28 to 41%)
Phase Six	€8bn<AANA≤€50bn	5,443	4,205 to 4,620 (78 to 85%)	823 to 1,238 (15 to 22%)

Key Issues:

- Strategy and tensions for dividing IM Threshold in Counterparty Group
- Strategy for documenting IM Pairings which may never breach the IM Threshold

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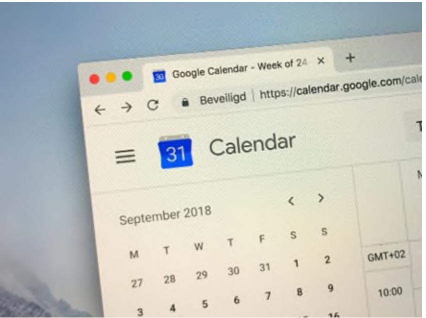
2. Phases 5 and 6

In light of the significant challenges posed by Covid-19, including the displacement of staff and the need for firms to focus resources on managing risks associated with current market volatility, the Committee and IOSCO have agreed to extend the deadline for completing the final two implementation phases of the margin requirements for non-centrally cleared derivatives, by one year. This extension will provide additional operational capacity for firms to respond to the immediate impact of Covid-19 and at the same time, facilitate covered entities to act diligently to comply with the requirements by the revised deadline.

8.8 From 1 September 2021 to 31 August 2022, any covered entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for March, April, and May of 2021 exceeds €50 billion will be subject to the requirements when transacting with another covered entity (provided that it also meets that condition).

8.9 On a permanent basis (ie from 1 September 2022), any covered entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for March, April, and May of the year exceeds €8 billion will be subject to the requirements described in this paper during the one-year period from 1 September of that year to 31 August of the following year when transacting with another covered entity (provided that it also meets that condition). Any covered entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for March, April, and May of the year is less than €8 billion will not be subject to the initial margin requirements described in this paper.



Relative to the 2019 framework the revision extend by one year the final two implementation phases of the margin requirements. With this extension, the final implementation phase will take place on 1 September 2022. This extended timeline will provide additional operational capacity for firms to respond to the immediate impact of the Covid-19 and at the same time, facilitate covered entities to act diligently to comply with the requirements by the revised deadline.

3. Physically settled FX Forwards & Swaps

The European Supervisory Authorities (EBA, EIOPA and ESMA – ESAs), in response to the COVID-19 outbreak have published joint draft Regulatory Technical Standards (RTS) to amend the Delegated Regulation on the risk mitigation techniques for non-centrally cleared OTC derivatives (bilateral margining), under the European Markets Infrastructure Regulation (EMIR), to incorporate a one-year deferral of the two implementation phases of the bilateral margining requirements.

Article 1

Amendment to Delegated Regulation (EU) 2016/2251

Delegated Regulation (EU) 2016/2251 is amended as follows:

(1) the following Article 31a is inserted:

"*Article 31a*

Treatment of physically settled foreign exchange forwards and physically settled foreign exchange swaps

4. Single-Stock Equity Options and Index Options

6. In Article 38, paragraph 1 is replaced by the following:

1. 'By way of derogation from Articles 36(1) and 37, in respect of all non-centrally cleared OTC derivatives which are single-stock equity options or index options, the Articles referred to in Articles 36(1) and 37 shall apply from 4 January 2021.'.

2.2.4 Temporary exemption for single-stock equity options and index options

22. As described above, the Commission Delegated Regulation on bilateral margining contains a range of implementation timelines, including a phase-in for the initial margin requirements as well as deferred dates of application for certain contracts and counterparties. In particular, the requirements for single-stock equity options or index options transactions are deferred until 4 January 2020.

27. With the view to continue monitoring regulatory developments in other jurisdictions and ensuring that appropriate requirements are in place in the Union to mitigate counterparty credit risk in respect of such contracts whilst avoiding scope for regulatory arbitrage, it would thus appear proportionate to extend by one year the current deferred application of the margin requirements for single-stock equity options or index options transactions in the EU framework. The draft RTS included in Annex contains this proposed amendment.

5. Intragroup Transactions

2.2.5 Temporary exemption for intragroup transactions

28. Another deferred date of application of the bilateral margin requirements relates to intragroup transactions with a third country entity in the absence of an equivalence decision adopted by the European Commission pursuant to Article 13(2) of EMIR. The requirements for these intragroup transactions are currently deferred until 4 January 2020.

29. ESMA already looked at this question from the perspective of the clearing obligation. After running a consultation, ESMA finalised and submitted a draft RTS to the European Commission on 27 September 2018 proposing to extend the temporary regime by two years until 21 December 2020. The draft RTS have since been endorsed, then published in the Official Journal and have entered into force.

30. The rationale for the exemption from the clearing obligation is the same as for the exemption from the bilateral margin requirements, i.e. broadly speaking that those deferred dates were necessary to ensure that such intragroup OTC derivate contracts were not subject to the EMIR clearing or bilateral margin requirements before the adoption of the relevant equivalence decisions.

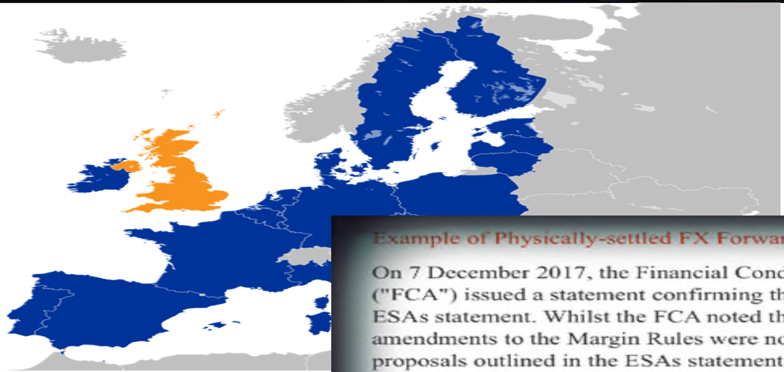
31. The ESAs are thus of the view that in light of this common rationale for a temporary exemption, it is proportionate to also extend the temporary exemption for bilateral

10

5. In Article 37(3), point (a) is replaced by the following:

(a) 'from 21 December 2020 where no equivalence decision has been adopted pursuant to Article 13(2) of Regulation (EU) No 648/2012 for the purposes of Article 11(3) of that Regulation in respect of the relevant third country;'.

When will it take Effect?



Example of Physically-settled FX Forwards

On 7 December 2017, the Financial Conduct Authority ("FCA") issued a statement confirming that it supported the ESAs statement. Whilst the FCA noted that the proposed amendments to the Margin Rules were not clear, the proposals outlined in the ESAs statement could be used by firms as an indication of what the amended requirements may look like. The FCA therefore confirmed that they would not require firms whose physically settled FX forwards are likely to be outside the scope of the amended requirements to continue putting processes in place to exchange variation margin.

esma European Securities and Markets Authority

EBA European Banking Authority

eiopa

Next Steps

This Final Report is sent to the European Commission, and the ESAs are submitting the draft technical standards presented in the Annex for endorsement in the form of a Commission Delegated Regulation, i.e. a legally binding instrument applicable in all Member States of the European Union. Following the endorsement, they are then subject to non-objection by the European Parliament and the Council.

The ESAs cannot disapply EU law. However, in view of the remaining steps mentioned above that the draft RTS need to go through before being finalised and entering into force, and in light of some of the soon approaching deadlines, with regards to the bilateral margin requirements and the treatment of physically settled FX forward and swap contracts, intragroup contracts, equity option contracts and the implementation of the last phase of the initial margin requirements as proposed in the draft RTS, the ESAs expect competent authorities to apply the EU framework in a risk-based and proportionate manner until the amended RTS enter into force.

In addition, these draft RTS are still subject to endorsement by the European Commission and a non-objection period by the European Parliament and Council, and thus legal certainty on the one-year extension proposal from the ESAs would only be confirmed after these steps and the publication in the Official Journal.

UMR Revision in US & Switzerland

The final rule from the the US Prudential Regulator for margin and capital requirements for covered swap entities has been effective since 11 May 2020: this rule exempts inter-affiliate swaps from initial margin requirements and establishes the new Phase 6.

Swiss margin regulators published rule amendments which started 1 January 2020 for Phase 6 in line with EU draft RTS and equity derogation amendments. FINMA will be extending the transitional provision for equity options under their regulations. Duty to exchange collateral applies from 4 January 2021 for non-centrally cleared OTC derivatives transactions that are options on individual equities, index options or similar equity derivatives such as derivatives on baskets of equities

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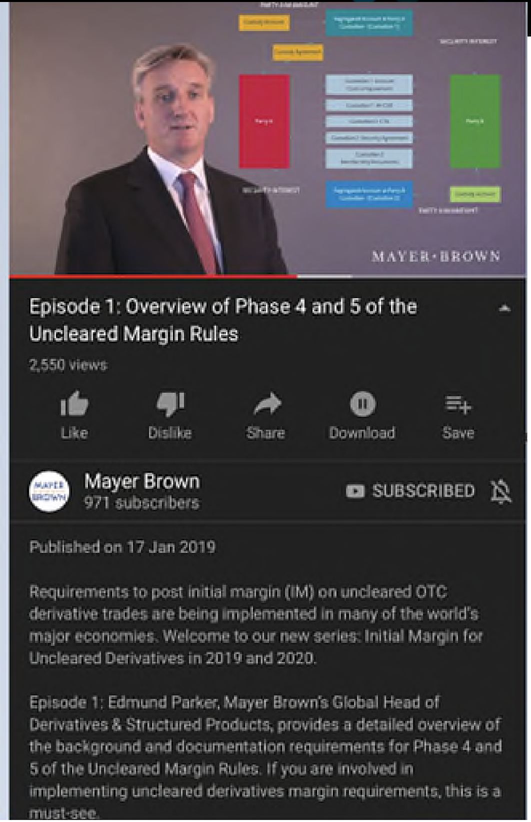

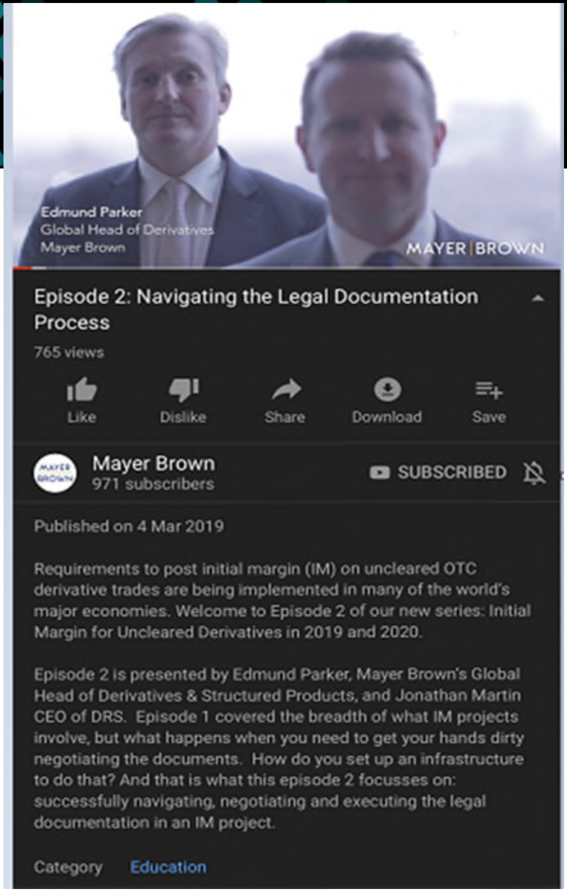

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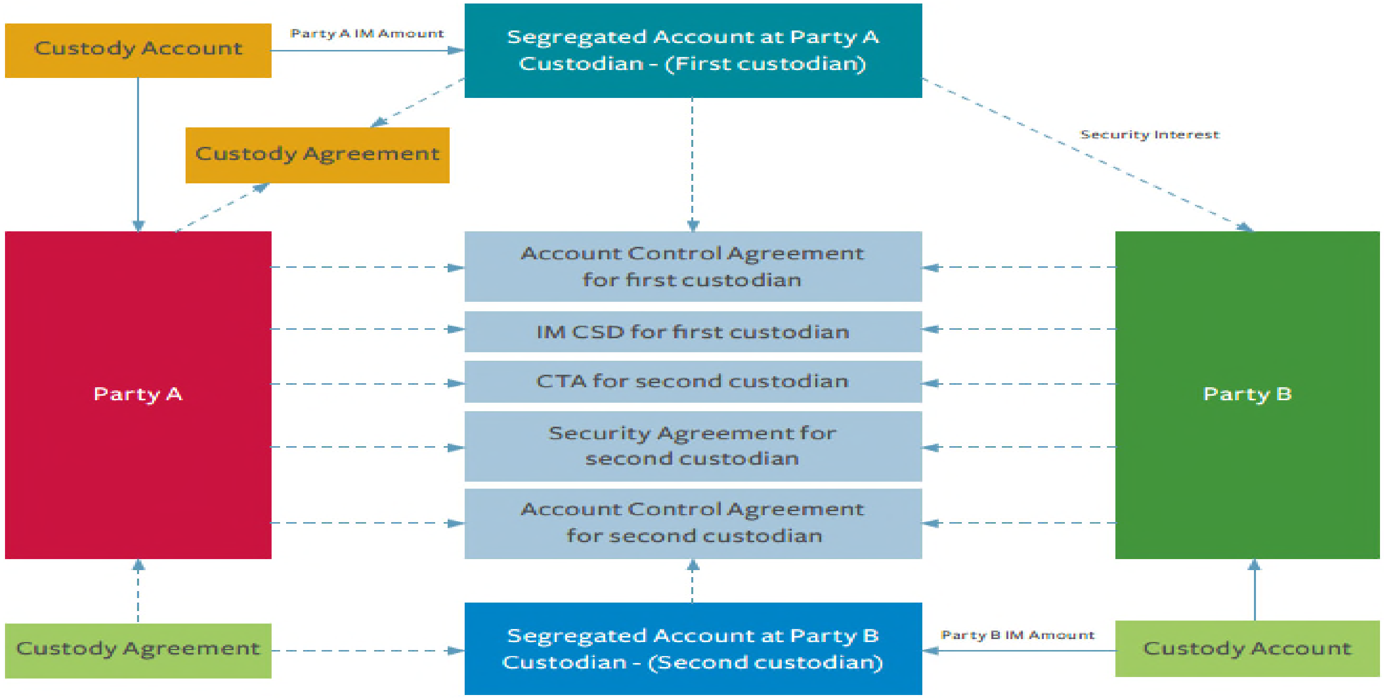

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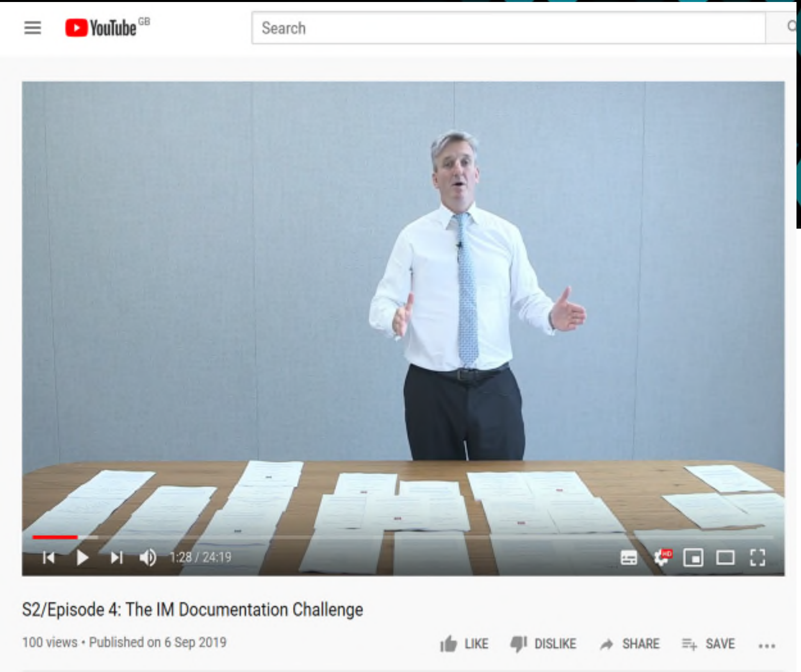
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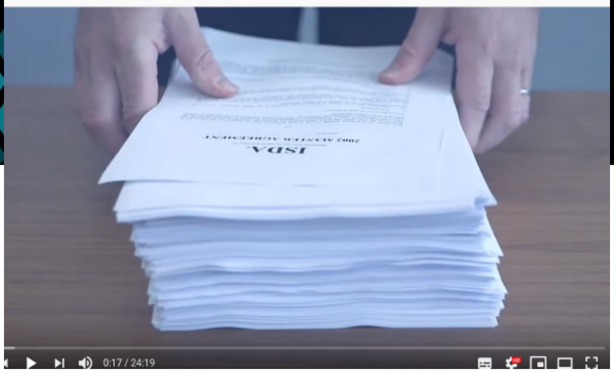
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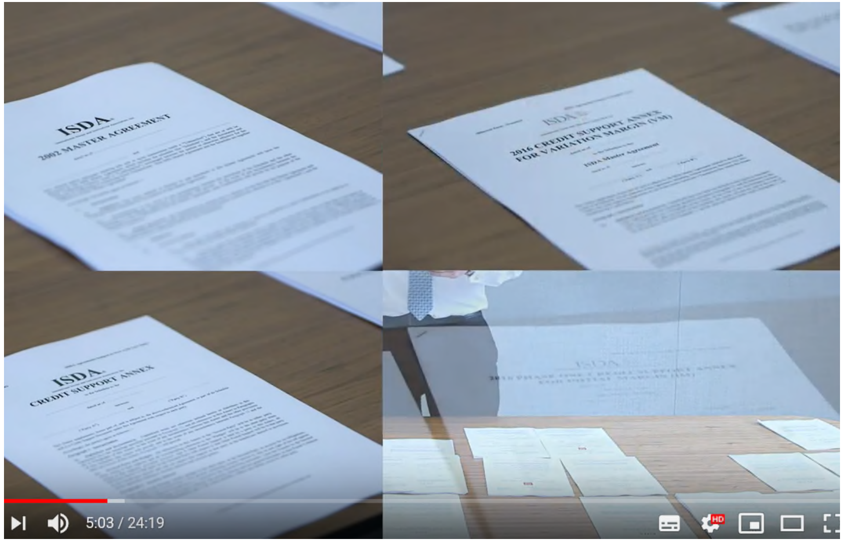
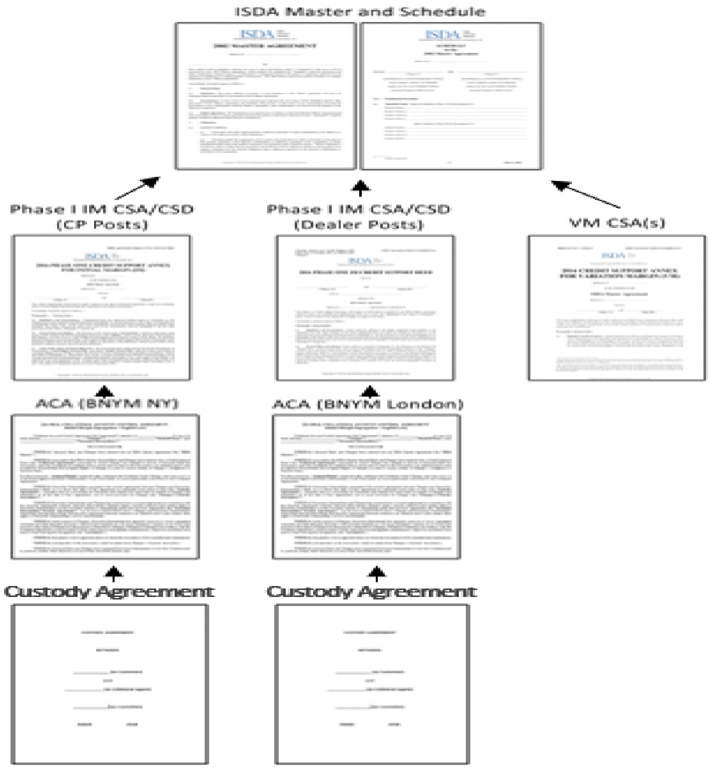
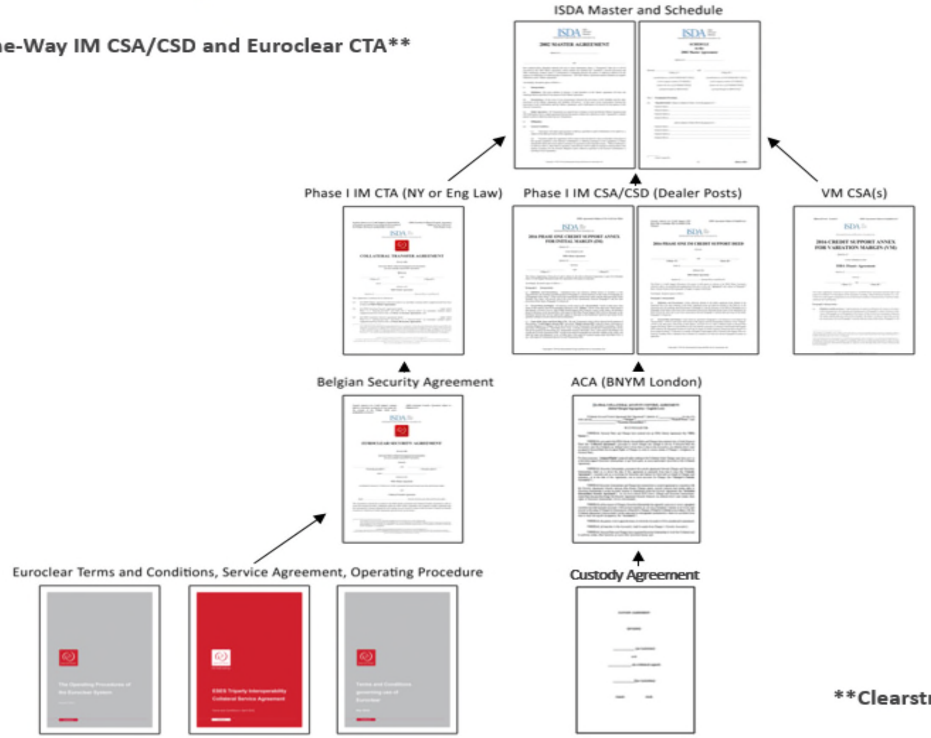
ISDA
2019 BELGIAN LAW SECURITY
AGREEMENT FOR INITIAL MARGIN (IM)
18:00 / 24:19


ISDA
2002 MASTER AGREEMENT
2016 CREDIT SUPPORT ANNEX
FOR VARIATION MARGIN (VM)
ISDA
CREDIT SUPPORT ANNEX
5:03 / 24:19

The Documentation Challenge



One-Way IM CSA/CSD and Euroclear CTA**



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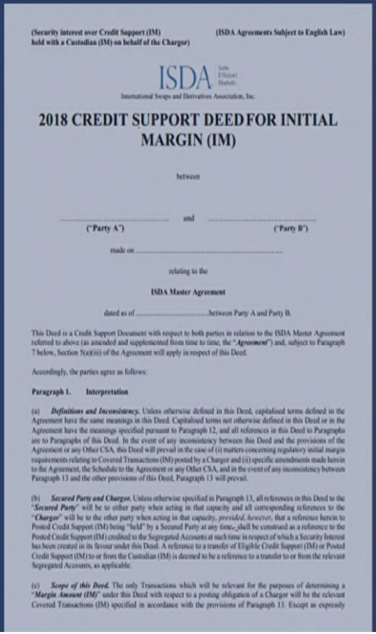

(Security interest over Credit Support (IM) held with a Custodian (IM) on behalf of the Chargor)

(ISDA Agreements Subject to English Law)

ISDA

International Swaps and Derivatives Association, Inc.

2018 CREDIT SUPPORT DEED FOR INITIAL MARGIN (IM)

between

.... and ....

("Party A") ("Party B")

made on ....

relating to the

ISDA Master Agreement

dated as of .... between Party A and Party B.

This Deed is a Credit Support Document with respect to both parties in relation to the ISDA Master Agreement referred to above (as amended and supplemented from time to time, the "***Agreement***") and, subject to Paragraph 7 below, Section 5(a)(iii) of the Agreement will apply in respect of this Deed.

Accordingly, the parties agree as follows:

Paragraph 1. Interpretation

(a) ***Definitions and Inconsistency.*** Unless otherwise defined in this Deed, capitalised terms defined in the Agreement have the same meanings in this Deed. Capitalised terms not otherwise defined in this Deed or in the Agreement have the meanings specified pursuant to Paragraph 12, and all references in this Deed to Paragraphs are to Paragraphs of this Deed. In the event of any inconsistency between this Deed and the provisions of the Agreement or any Other CSA, this Deed will prevail in the case of (i) matters concerning regulatory initial margin requirements relating to Covered Transactions (IM) posted by a Chargor and (ii) specific amendments made herein to the Agreement, the Schedule to the Agreement or any Other CSA, and in the event of any inconsistency between Paragraph 13 and the other provisions of this Deed, Paragraph 13 will prevail.

(b) ***Secured Party and Chargor.*** Unless otherwise specified in Paragraph 13, all references in this Deed to the "***Secured Party***" will be to either party when acting in that capacity and all corresponding references to the "***Chargor***" will be to the other party when acting in that capacity, *provided, however,* that a reference herein to Posted Credit Support (IM) being "held" by a Secured Party at any time, shall be construed as a reference to the Posted Credit Support (IM) credited to the Segregated Accounts at such time in respect of which a Security Interest has been created in its favour under this Deed. A reference to a transfer of Eligible Credit Support (IM) or Posted Credit Support (IM) to or from the Custodian (IM) is deemed to be a reference to a transfer to or from the relevant Segregated Accounts, as applicable.

(c) ***Scope of this Deed.*** The only Transactions which will be relevant for the purposes of determining a "***Margin Amount (IM)***" under this Deed with respect to a posting obligation of a Chargor will be the relevant Covered Transactions (IM) specified in accordance with the provisions of Paragraph 13. Except as expressly

THE 2018 CREDIT SUPPORT DEED FOR IM (ENGLISH LAW)

- Determining the types of trade caught by IM requirements: "Covered Transactions";
- Determining how IM must be held: transfer provisions; prevention of re-hypothecation; using segregated accounts and custody arrangements;
- Determining the Frequency of IM exchange;
- Determining the amount of IM to be posted, through definitions of Credit Support Amount; Margin Amount (IM); and Minimum Transfer Amount;
- Providing for what type of collateral can b[...] is Eligible Collateral and what is Ineligible[...]
- Which Regulatory Regimes apply.

2018 Credit Support Annex For Initial Margin (IM) (Security Interest – New

ISDA Clearstream Documents (2019)

The following documents are used to document a collateral arrangement between two parties where the...

Read more ➔

Free downloads (9)

- ISDA Clearstream Collateral Transfer Agreement (2019) (zip)
- Blackline ISDA 2016 Clearstream CTA (English Law) v ISDA 2019 Clearstream CTA (pdf)
- ISDA 2019 Clearstream Security Agreement (Luxembourg Law)_Security-provider name (zip)

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ISDA Euroclear Documents (2019)

The following documents are used to document a collateral arrangement between two parties where the...

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Free downloads (8)

- ISDA 2019 Euroclear Security Agreement (zip)
- Blackline of ISDA 2019 Euroclear Security Agreement vs 2018 version (pdf)
- ISDA Euroclear Collateral Transfer Agreement (2019) (zip)

IM Collateral Documents for use with a Bank Custodian (2019)

The following documents are used to document a collateral arrangement between two parties where the...

Read more ➔

Free downloads (7)

- ISDA 2019 Bank Custodian Collateral Transfer Agreement for Initial Margin (IM) (zip)
- ISDA 2019 English Law Security Agreement for Initial Margin (IM) (zip)
- ISDA 2019 New York Law Security Agreement for Initial Margin (IM) (zip)

2018 Credit Support Annex For Initial Margin (IM) (Security Interest – New York Law)

The 2018 Credit Support Annex For Initial Margin (IM) allows parties to establish initial margin arrangements that meet the requirements of margin regulations for uncleared swaps. ISDA previously published the 2016 Phase One IM Credit Support Annex to support Phase 1 of the initial margin requirements. The 2018 document has been adapted from the 2016 form for use by buy- and sell-side firms in view of the expansion of the impact of IM regulations to firms coming into scope in September 2019 (Phase 4), September 2020 (Phase 5) or later. Like the 2016 Phase One IM Credit Support Annex and the 1994 ISDA Credit Support Annex (Security Interest – New York Law), this document serves as an Annex to the Schedule to the ISDA Master Agreement and creates a New York law security interest over collateral. A blackline against the 2016 Phase One IM Credit Support Annex is also included.

Client Clearing and FRANDT

FRANDT under EMIR Refit and Impact on Client Clearing Agreements

- The importance of client clearing agreements for OTC derivatives
- Different contractual perspectives of clearing brokers (direct / indirect) and clients (direct / indirect) compared to pure uncleared OTC trading
  - Clearing brokers provide a "service" and need to achieve a risk-less-principal position (including from a CRR perspective)
  - Clients need (stable) clearing access at reasonable risks/costs
- Type of agreements used in the market, complexity of structures and terms:
  - ISDA based documentation / FIA futures and options based documentation / German clearing master agreement <u>and</u> indirect clearing arrangements
  - Less standardisation compared to uncleared OTC master agreement in relation to additional (protective) terms used by clearing brokers; clearing broker agreements deviation substantially from each other
  - Negotiations are therefore often complex and long

FRANDT under EMIR Refit and Impact on Client Clearing Agreements

- FRANDT (Article 4 (3a)): Requirements for clearing brokers (direct / indirect) to offer clearing services under commercial terms that are considered *fair*, *reasonable*, *non-discriminatory* and *transparent*
- Regulatory purpose of FRANDT:
  - Clients (direct / indirect) rely on the availability of clearing access due to their clearing obligation under EMIR
  - Increase and facilitate access to clearing
  - <u>But</u>: clearing brokers need to be allowed to run commercially viable and risk prudent businesses
  - A "careful calibration" is therefore needed
- Applies to all clients even sophisticated clients (no tiering of clearing clients)
- Final Report of ESMA published of 2 June 2020 providing for the details of FRANDT implementation by way of a Level 2 implementation

FRANDT under EMIR Refit and Impact on Client Clearing Agreements

- Main aspects of the FRANDT RTS:
  - Transparency through disclosures in line with existing regulations under EMIR, Del Reg 2017/589 and 149/2013 on indirect clearing (description of onboarding process and key commercial terms, but not the client clearing agreements as such)
  - Standardised onboarding framework, including a standardised negotiation process:
    - (Standardised) Request for Proposal provided by Client (RFP)
    - (Standardised) Proposal for the Provision of Clearing Services by Clearing Broker: includes inter alia scope of service, fees, collateral and key contractual terms which must show deviations from a market standard clearing (master) agreement). Proposal must be valid and binding for three months.
    - Agreed Term: must be presented in a clear and easily understandable manner. Need to include information comparing the Agreed Terms with the Proposal
  - (Standardised) fee presentation

FRANDT under EMIR Refit and Impact on Client Clearing Agreements

- Main aspects of the FRANDT RTS (con‘t):
  - Non-discriminatory risk assessment
  - (Mandatory) regulation of the terms of the client clearing agreement:
    - List of contracts
    - Reference to a market standard agreement + annex with amendments/elections/additional terms (justified by credit risk, regulatory requirements, market practices or other business requirements) … additional material contract terms shall be reasonable and relevant.
    - Avoid overlapping and contradictory terms (e.g. by including CCP clearing conditions)
    - No ordinary termination shorter than 6 months unless such shorter period is reasonable and justified
    - Material amendments to contract shall be communicated (where possible) with a sufficient notice in advance + justification for the change shall be provided
    - Unilateral amendment rights with material impact might be challenged as non FRANDT compliant
    - In addition, the Final Report discussed the FRANDT requirements on one-sided close-out provisions (no clearing broker EODs) as well as one-sided optionality in accepting orders (give certainty)

FRANDT under EMIR Refit and Impact on Client Clearing Agreements

- Other (open) questions:
  - Scope of FRANDT (all clearing services in the EU through a recognised or authorised CCP, not ETD, but voluntary clearing?)
  - Non compliance and civil law effects
  - Legacy contracts prior to the entering into force of the RTS: formal requirements might need to be phased and only apply to new contracts but FRANDT applies as such also to existing contracts!

Chris Arnold, Ed Parker, Patrick Scholl

Coronavirus Crisis I: Impacts on Derivatives / Crisis II: Preparation for Defaults under Master Agreements and Credit Derivatives

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COVID-19: Issues for OTC Derivatives

- Force Majeure / frustration
- Unscheduled holidays and Market Closures
- Emergency insolvency legislation
- Payment moratoria
- Regulatory Margining – procyclical and other effects
- Electronic signatures

COVID-19: Credit Derivatives

- The "$2.6 billion big short" – was it fair value?
- 12 CDS Credit Events globally since 1 March 2020:
  - 9 US Corporates (retailers, oil companies, communications)
  - 3 EM Sovereigns (Argentina; Ecuador; Lebanon)
  - <u>Zero</u> European Credit Events
- Fewer Credit Events than expected (?) but historically low recoveries
  - Auction Final Price average 22.9% in 2020 (versus 43.2% since 2005)

COVID-19: Credit Derivatives

- Likelihood of more Credit Events but emerging indications that level could be reduced by factors including:
  - Introduction of provisions prohibiting "Narrowly Tailored Credit Events"
  - Relaxation of insolvency rules
  - Novel resolution measures
  - Pressure on creditors to forbear on enforcement
  - Subordination of creditors due to collateral arrangements that may fall outside scope of definitions
  - Lack of 'Publicly Available Information' on government bail-outs

Close-Out Preparation under ISDA

5. Given that this is a version of a standard form which is still in regular use as a template throughout the world, the way in which I determine the issues of construction is bound to have ramifications beyond this case. In particular, I have to decide whether the different means of giving notice set out in s.12 are mandatory or permissive, and whether the phrase "electronic messaging system" used in the 1992 form embraces emails. Unfortunately, unlike Briggs J. (and the Court of Appeal) in Lomas v JFB Firth Rixon, I do not have the assistance of submissions from ISDA itself, and there has been no expert evidence on market practice.

89. Part 4 of the Schedule contains no fax number for Greenclose and no email address for Mr Reynolds (the named contact) or anyone else. Therefore, unless a notice of change was given under s.12(b), if s.12 (a) of the Master Agreement (read together with the Schedule) is mandatory, the ways in which an effective notice could be given to Greenclose would be in writing (delivered in person or by courier) or by registered or certified mail. None of these methods was used by the Bank. Although some argument was addressed to me about whether the fax number provided by Mr Leach at Mr Jones' request for the purposes of transmitting the post-transaction acknowledgement, (and used thereafter for transmitting the quarterly position statements) was implicitly incorporated into the Schedule, I do not need to decide that point, since the attempt to send the notice by fax to Greenclose failed.

129. In any event, the phrase "*Electronic Messaging System*" in the 1992 ISDA Master Agreement does not include email. In 1992, email was not in common use and thus the reference to "electronic messaging system" is unlikely to have been intended to include it. Nor is it possible to conclude that over time, with the developments in computer technology, the meaning of that expression altered or that the expression must necessarily be construed as including any types of electronic messaging system that became more prevalent or were developed after the form was originally drafted. The distinction expressly drawn in the ISDA definition of "*Confirmation*" (referred to above) between electronic messaging systems and email, the suggested amendment to section 12 (a) in 2001, the changes to that section in the 2002 Master Agreement to include email for the first time, and the reasons given for this by ISDA itself, make it plain that the expression was never intended to embrace email, and that specific provision had to be made to include email after it became a common form of communication. That view is supported by commentators. I have

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Close-Out Preparation under ISDA

IMPLIED TERMS

144. In the light of my conclusions on the notice point, it is unnecessary for me to address Greenclose's alternative case. However in deference to the detailed submissions from both parties, and in case this matter goes further, I will deal with the case on implied terms as succinctly as possible. In my judgment none of the suggested terms meets the test for an implied term set out by Lord Hoffmann (delivering the judgment of the Privy Council) in Attorney General of Belize v Belize Telecom [2009] 1 WLER 1988 at [16]-[27] as endorsed and clarified by the Court of Appeal in The Reborn [2009] 2 Lloyd's Rep 639. None of the suggested terms is necessary to give effect to the reasonable expectations of the parties to the Collar.

Event of Default Notice

Legal dept. approves notice

Paralegals deliver notice

EVENT OF DEFAULT NOTICE

24 June 2020
Cadiz SA

Attention: Documentation Manager
Fax:

Re: <u>Notice designating an Early Termination Date</u>

Dear Sirs:

Reference is made to the 1992 ISDA Master Agreement (Multicurrency-Cross Border), dated as of 28 January 2007, between Fortis and Cadiz SA (the "<u>Counterparty</u>") (as amended, supplemented or modified, and including all schedules, annexes and exhibits thereto, and all confirmations exchanged pursuant to Transactions entered into in connection therewith, the "<u>Master Agreement</u>"). Capitalized terms used but not defined herein shall have the meanings ascribed to them in the Master Agreement.

Fortis hereby gives notice that an Event of Default with respect to the Counterparty under Section 5(a)(vii) of the Master Agreement has occurred as a result of the bankruptcy filing of the Counterparty.

Accordingly, pursuant to Section 6(a) of the Master Agreement, Fortis hereby designates the date hereof as the Early Termination Date in respect of all outstanding Transactions under the Master Agreement.

The consequence of the designation of an Early Termination Date is that:
(a) no further payments or deliveries under Section 2(a)(i) or 2(e) of the Master Agreement will be required to be made in respect of the Transactions under the Master Agreement; and
(b) the amount, if any, payable in respect of the Early Termination Date shall be determined pursuant to Section 6(e) of the Master Agreement or as otherwise specified in the Master Agreement.

In accordance with Section 12(a) of the Master Agreement and Part 4(a) of the Schedule to the Master Agreement, this notice is being delivered during normal business hours and will be deemed effective on the date of delivery.

Yours faithfully,
Fortis

By:
Name:
Title:

Weaknesses in the Close-Out Mechanism

Pitfalls for the Unwary

- The fact that a party's office building is closed e.g. because of a pandemic/ lockdown, does not necessarily mean that listed methods of giving notice cannot be used
- Where this is specified it must be delivered to the correct floor of the building
- A notice sent by fax will be effectively given only if it is received by a responsible employee of the recipient in legible form

COVID-19: Default Management under DRV/CRV

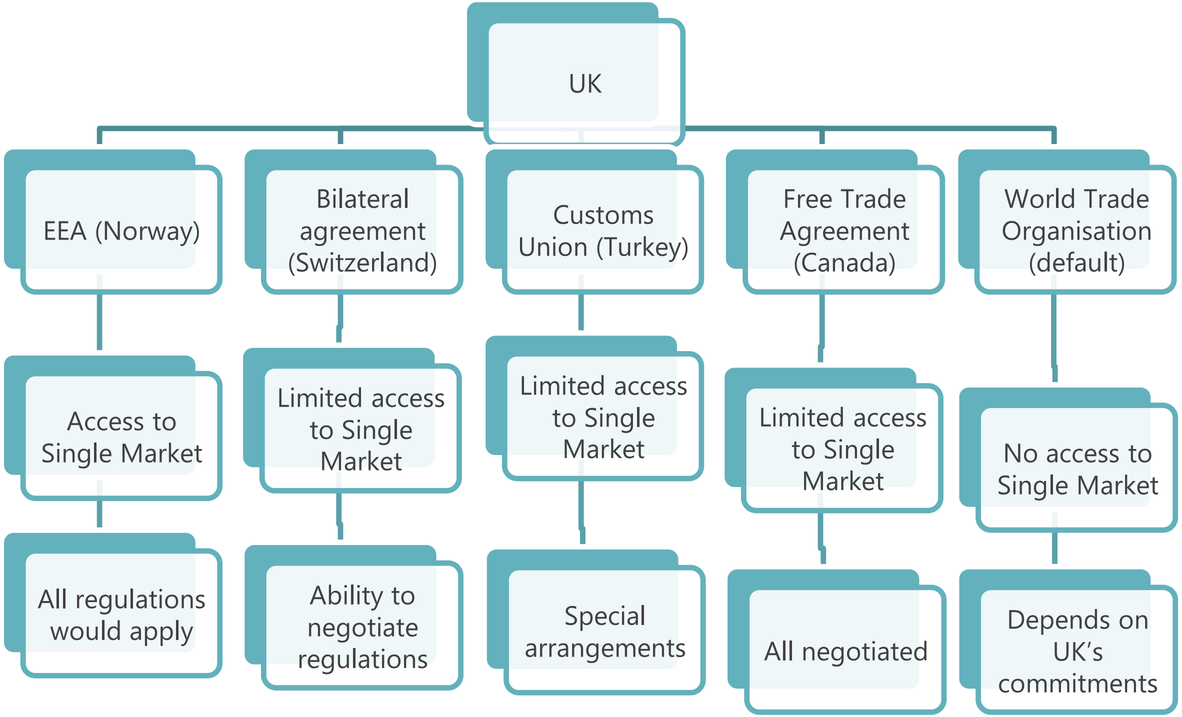
- DRV/CRV (based on new 2018 and 2019 version)
  - Termination for material cause, in particular
    - Non payment for 3 working days
    - Non delivery of VM or IM collateral within one banking day
    - Other individually agreed termination events
  - Automatic termination in case of an event of insolvency
  - Termination notices can be delivered in written form

Chris Arnold, Ed Parker, Patrick Scholl

Brexit Preparations

MAYER BROWN

Flashback I: What we said to You in 2016 in Frankfurt - Brexit Options



Flashback II: What we said to You in 2018 in Frankfurt - Road to Brexit

October 18–19, 2018:
EU Council. Brexit deal is put to European leaders. It needs approval from at least 20 of the 27 member countries.

October 2018:
MPs vote on the **final Brexit deal**, including a political declaration about the future UK-EU relationship.

2019

March 29, 2019:
UK leaves the EU, but remains signed up to many of its rules for a transition period while it negotiates a free-trade deal.

2020

December 31, 2020:
Transition period ends. The UK aims to have signed a free-trade deal with the EU.

Articles, posts & more...

Articles | Posts | Activity | Interests

Edmund Parker
Partner, Global Head of Derivatives & Structured Products
1yr

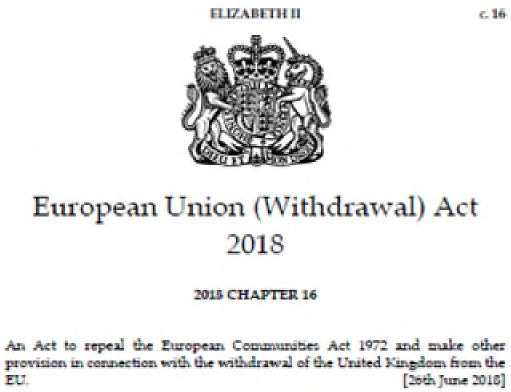
Yesterday was our fourth annual OTC Derivatives Seminar at the Mayer Brown Frankfurt office. Our second seminar in 2016 fell two days after the Brexit vote, and we cobbled together a short presentation on the effect of Brexit on the derivatives market. This time there was much more detail, and we presented a focussed session to our German clients on the good, the bad and the ugly effects of Brexit on the derivatives market, looking at potential Events of Default, Termination Events and jurisdiction and forum issues for the ISDA Master Agreement; bulk transfer and novation issues; passporting, licensing and regulation; and the political climate. Thank you to our German clients for attending yesterday.

#regulations #brexit #derivatives #isda #frankfurt #mayerbrown

Flashback III: What we said to You in 2019 in Frankfurt - Further English Law Issues

- **No Deal Amendments to ISDA Documentation:**
- **Confidentiality Waiver**
- **ISDA EMIR PDD Protocol**
- **Margin Documentation**
- **Contractual Recognition of Bail-in and Resolution Stays**
- **MiFIR Portfolio Compression**
- **Governing Law & Choice of Law issues**

UK Perspective – Brexit



ELIZABETH II c. 16

European Union (Withdrawal) Act 2018

2018 CHAPTER 16

An Act to repeal the European Communities Act 1972 and make other provision in connection with the withdrawal of the United Kingdom from the EU. [26th June 2018]

2 March 2020

Future relationship negotiations commence

12 March 2020

Negotiations suspended in light of Covid-19 pandemic

20 April 2020

Negotiations re-commence

30 June 2020

Deadline by which the EU and UK have to decide whether to extend the transition period

1 January 2021

End of Transition Period

Challenges for ISDA Master Agreements

- Breach of representation and/or agreement?
- Additional termination rights?
- Impact on governing law?
- Will Rome I and II apply?

Alternative ISDA Agreements: Have they gained Traction? Why has Brexit complicated IM?

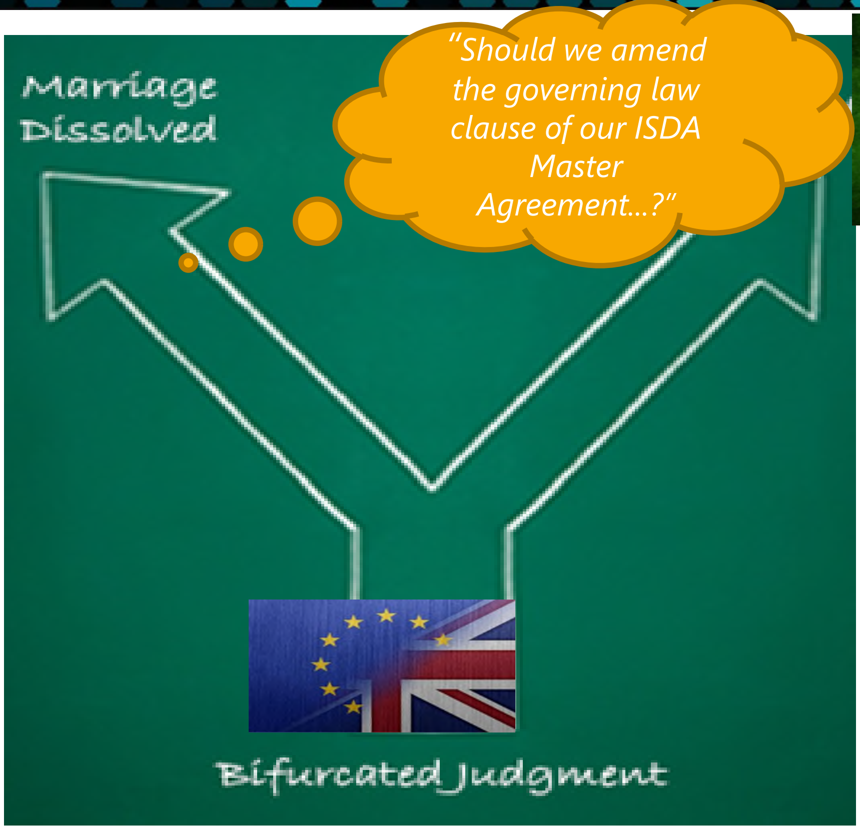

(French law)

ISDA Safe, Efficient Markets

International Swaps and Derivatives Association, Inc.

2002 MASTER AGREEMENT

CONTRAT-CADRE 2002




(Irish Law)

ISDA Safe, Efficient Markets

International Swaps and Derivatives Association, Inc.

2002 MASTER AGREEMENT

Third-Country Regimes – Prescient UK Views

CESR

HM Treasury

FSA Financial Services Authority

Is it necessary to introduce a third-country regime in MiFID based on the principle of exemptive relief for equivalent jurisdictions?

- *"...potential to undermine both the principle of open markets and the ability of EU firms to do international business"*
- *"make the EU markets less open than they currently are"*
- *"likely to involve very significant time and effort as regulatory systems are compared"*
- *"This task will be made much harder if the standard being assessed is 'strict equivalence'"*
- *"we do not believe that the introduction of a mechanism for exemptive relief should be used as a tool to demand reciprocity from other jurisdictions. It would be a poor outcome if EU firms were to lose existing access to any third-country jurisdictions."*

EU Perspective: For Example Germany

- Brexit Transition Act (*Brexit-Übergangsgesetz*) of 27 March 2019 (came into force on 1 February 2020)
  - → Clarifies that German national laws which are linked to the status as a Member State are also applicable to the UK during the transitional period
- If 31 December 2020 remains as the end of the transition period and the negotiating parties are unable to reach a further, more comprehensive agreement by that date, the withdrawal agreement and the arrangements thereunder will only cover specific areas. Many points concerning the financial markets would remain unresolved.
- Consequences for cross-border transactions? Passporting rules?
  - Same as for the threatening hard-Brexit scenarios before?
  - Further action of the German legislator necessary?

EU Perspective: For Example Germany

- Passed German law for the event of a no-deal Brexit (on 25 March 2019)
  - Article 53b para. 12 of the German Banking Act (*KWG*) was implemented by the Brexit Tax Accompanying Act (*Brexit-Steuerbegleitgesetz*)
  - According to such provision, the German Federal Financial Supervisory Authority (*BaFin*) may determine (by way of administrative decision (*Verwaltungsakt*) or general decree (*Allgemeinverfügung*) that the regulations for the European passport shall apply in full or in part to businesses based in the UK from the time of the unregulated / “no-deal” Brexit
  - The purpose of the regime was to ensure the regulatory permissibility of the fulfilment of existing contractual obligations for a transitional period to the extent necessary to avoid disadvantages for the functioning or stability of the financial markets

EU Perspective: For Example Germany

- Passed German law for the event of a no-deal Brexit (on 25 March 2019) (con't)
  - However, link to existing business required: Continued applicability of the passporting regime only if respective UK companies conduct banking business or provide financial services which are closely related to contracts already existing at the time of the unregulated / "no-deal" Brexit
  - But: Since 31 January 2020 a "no-deal Brexit" is no longer possible as the UK and the EU entered into the withdrawal agreemen
  - → Amendment necessary to cover "insufficient deal Brexit" for financial markets?

A GLOBAL PRACTICE

Recognized across each of our regions for excellence in derivatives and structured products.

TOP RANKED Chambers GLOBAL 2020

Ranked by *Chambers Global* for **Global-wide: Capital Markets: Structured Finance & Derivatives**. Also ranked for Europe-wide: Capital Markets: Structured Finance; Germany: Capital Markets: Structured Finance; UK: Capital Markets: Structured Finance & Derivatives; and USA: Capital Markets: Derivatives.

GlobalCapital

Named **Global Law Firm of the Year** by *GlobalCapital* at the 2019 Global Derivatives Awards.

AMERICAS

GlobalCapital

Named **US Law Firm of the Year – Transactional** in 2020 and **Americas Law Firm of the Year** by *GlobalCapital* at the 2019 and 2018 Americas Derivatives Awards

TOP RANKED Chambers USA 2020

Ranked by *Chambers USA* for Nationwide: Capital Markets: Derivatives

IFLR1000

Ranked by *IFLR1000* for Derivatives and Structured Finance & Securitisation in the United States

The LEGAL 500

Ranked Tier 1 for Structured Finance: Derivatives & Structured Products by *Legal 500 US*

Best Lawyers BEST LAW FIRMS USNews RANKINGS

Ranked by US News/ Best Lawyers' Best Law Firms for Derivatives and Futures Law

EUROPE

TOP RANKED Chambers UK 2020

Ranked by *Chambers UK* for London (Firms): Capital Markets: Derivatives

RANKED IN Chambers EUROPE 2020

Ranked by *Chambers Europe* for Capital Markets: Structured Finance* Europe-wide and in Germany

IFLR1000

Ranked by *IFLR1000* for Derivatives in the UK and Structured Finance* & Securitisation in Germany and France

The LEGAL 500

Ranked by *Legal 500 Deutschland* for Capital Markets: Structured Finance* and Securitisation and ranked by *Legal 500 UK* for Derivatives (including commodities) and for Structured products and securitization.

ASIA

TOP RANKED Chambers ASIA PACIFIC 2020

Ranked by *Chambers Asia-Pacific* for Banking & Finance: Capital Markets* in China and Vietnam

IFLR1000

Ranked by *IFLR1000* for Structured Finance* & Securitisation in Hong Kong

The LEGAL 500

Ranked by Legal 500 Asia-Pacific for Hong Kong: Structured Finance* and Securitisation and for Vietnam: Capital Markets

*Includes derivatives & structured products rankings.

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