Hogan Lovells

Derivatives: The year ahead for U.S. commercial end users, funds, and other financial end users

With 2020 now behind us, we look forward to the year ahead while noting just one of the many lessons of the past year: the difficulty of prediction.

We simplify the task by limiting our focus to five topics in derivatives that should be important to commercial end users, funds, and other financial end users that trade derivatives.

1. In the beginning of 2021, we expect swap dealers to contact you, if they have not already, regarding the ISDA 2020 IBOR Fallbacks Protocol (the **Protocol**).
2. For those that are financial end users, on March 1, 2021, the three-month calculation period begins to determine whether your corporate group's average aggregate notional amount of derivatives (**AANA**) exceeds the US$50 billion threshold and puts you in scope for the initial margin requirements as of September 1, 2021.
3. August 6, 2021 marks the earliest possible compliance date for security-based swap dealers, ushering in the beginning of the U.S. Securities and Exchange Commission (the **SEC**) overseeing security-based swap dealers, paralleling the swap dealer regulations of the Commodity Futures Trading Commission (the **CFTC**). As a result, certain transaction-level requirements such as reporting and margin will begin to apply to security-based swaps, potentially resulting in the need to update additional trade documentation.
4. Clients should be aware of the increased usage of electronic signatures and perhaps even the adoption of smart derivatives contracts by dealers.
5. Finally, we discuss how the incoming Biden Administration may alter the CFTC's policy agenda.

1. LIBOR transition

If they have not contacted you already, you should expect to hear from your swap dealers regarding adherence to the Protocol. Notwithstanding the recently announced plan to cease the publication of certain USD LIBOR tenors in the Summer of 2023, we expect dealers to encourage counterparties to adhere to the Protocol now.

The Protocol updates adherents' existing trading documentation to account for the cessation of USD LIBOR (among other reference rates).

You can read more about the LIBOR transition in the derivatives market and the Protocol, which becomes effective on January 25, 2021, from our prior client alert here.

You can also request access from our business development support team to view a replay of our LIBOR protocol presentation here.

2. Initial margin

For further information, please visit our previous client alert on initial margin here.[1]

[1] Note that due to the pandemic, the 2020 compliance date referenced in our previous client alert has been delayed until 2021.

If you are a financial end user, you are already subject to two-way variation margin when trading uncleared derivatives with swap dealers. If your derivatives activity exceeds the US$50 billion notional threshold during March, April, and May 2021, then the initial margin requirements will also apply to your uncleared derivatives.

Unlike variation margin, initial margin must be posted to a segregated account at an unaffiliated custodian. As such, the documentation is more complex and time intensive. It includes both an additional ISDA credit support annex for initial margin and tri-party documentation between you, the swap dealer, and the third-party custodian. Initial margin preparation includes operational readiness and executing a new suite of trading documentation, which is qualitatively different from the documentation architecture for variation margin.

3. Security-based swaps

Swap dealers began to register with the CFTC in 2012. Security-based swap dealers will begin to register with the SEC in the Fall of 2021. The CFTC's jurisdiction is over "swaps" while the SEC has jurisdiction over "security-based swaps." Credit and equity derivatives on single assets or narrow indices or baskets are "security-based swaps" while credit and equity derivatives on a broad-based index, fixed income derivatives, certain foreign exchange derivatives and energy, agricultural and metals derivatives are classified as "swaps."

If your swap dealer is a U.S. bank, then the margin requirements already apply to uncleared security-based swap. However, upon security-based swap dealer registration, dealers that trade in security-based swaps will become subject to additional requirements, such as reporting and recordkeeping. As a result, commercial end users, funds, and other financial end users that trade credit and equity derivatives on single assets or narrow indices or baskets may need to amend or supplement existing trading documentation and onboarding documents to be able to continue trading security-based swaps.

Mandatory clearing of security-based swaps could also result in updated trading documentation for funds and financial end users that trade these products.

Commercial end users that trade these products may need to update their governance documents related to the annual end user exception to clearing, though mandatory clearing of security-based swaps may not occur this year.

4. Electronic contracts and signatures

Even before the pandemic, ISDA had begun a project to commission opinions on the enforceability of electronic signatures in many jurisdictions, including the United States. Over the last year we have seen a significant increase in parties' willingness – and even preference – to execute contracts electronically.

If your company's operational capabilities or governance documents do not contemplate or cannot accommodate electronic signatures, it may be time to consider an update.

Looking further ahead, ISDA has had various initiatives to encourage the market to consider evolving towards more standardized, digitized, and ultimately automated contracts. The build-out will undoubtedly take time and fall most heavily on the dealers, but commercial end users, funds, and other financial end users would do well to consider their technical resources and personnel to ensure they are ready for the increasing application of technology to derivatives trading.

5. CFTC personnel changes and priorities

With the incoming Biden Administration, the departures of Division of Enforcement Director James McDonald and Market Participants Division Director Joshua B. Sterling, and Heath Tarbert planning to step down from his role as Commissioner this month, the CFTC's policy priorities may likely shift in tandem with these personnel changes.

In addition, now that the CFTC has completed its major Dodd-Frank rulemakings, the CFTC may continue to broaden its focus to include topics such as climate threats to derivatives markets, which it has already begun to evaluate.[2]

[2] See the CFTC's Climate-Related Market Risk Subcommittee of the Market Risk Advisory Committee's report, "Managing Climate Risk in the U.S. Financial System," available here.

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