COVID-19 Implications for the OTC Derivatives Markets

A Lexis Practice Advisor® Practice Note by Fabien Carruzzo, Gilles Kolifrath, Daniel King, Jeruska Lugo Sánchez, and Linda Sharkey, Kramer Levin Naftalis & Frankel LLP

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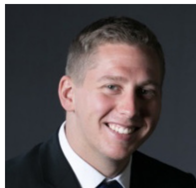

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With the continuing spread of the COVID-19 pandemic across the globe, and the economic downturn in its aftermath, its full implications remain unknown. For OTC derivatives market participants, COVID-19 raises a number of considerations that firms should take into account as they develop risk management strategies and adapt to ongoing developments. This article addresses a number of issues for market participants to consider.

For more, see:

- Coronavirus (COVID-19) Resource Kit
- ISDA Master Agreement: A Practical Guide
- Credit Derivatives Fundamentals
- Financial Derivatives

Market Disruption Events

There are a number of ways in which COVID-19 could disrupt a particular market. Firms should:

- identify trades in their portfolio that are susceptible to disruption due to market closures, trading suspensions, and the unavailability of rates or other pricing information;
- assess the likelihood of disruption based on the location and resilience of the applicable market; and
- understand the trigger events and fallbacks that may be implicated as a result of a disruption and the consequences of those potential disruptions and applicable fallbacks.

Equity Transactions

The 2002 ISDA Equity Derivatives Definitions specifically contemplate events that may disrupt pricing, valuation, or settlement of a transaction. Those events include (i) Trading Disruption, (ii) Exchange Disruption, and (iii) early closing.

These disruptions may arise as a result of a government-imposed market closure or similar actions taken by exchanges.

Generally speaking, the consequences of such events will result in deferred settlement, with pricing and valuation postponed for up to eight days. Where disruptions impact heavily traded markets (such as the U.S. stock markets), dealers (via ISDA working groups) may also agree on an industrywide approach in that respect, as was most recently the case when U.S. markets were closed following the death of President George H.W. Bush. However, where disruptions are sudden or in smaller markets, market participants should consider the discretion their dealer counterparties have in that respect. Market participants should also review their agreements to determine whether the calculation agent has broader discretion to determine the consequences of a disruption event.

FX Transactions

While it appears unlikely that foreign exchange (FX) trades will be subject to pricing or valuation disruptions similar to what could happen in the equity markets, it is conceivable that temporary market or bank closures could impact pricing or settlement. If that were the case, the 1998 ISDA FX and Currency Options Definitions provide for a number of fallbacks. Market participants should ensure they are aware of the applicable fallbacks in their documentation, which may eventually give rise to a determination by the calculation agent or a no-fault termination of the transaction under Section 6(e) of the master agreement.

Commodity Transactions

As with equity transactions, exchange closures may result in valuation, pricing, and settlement issues for commodity transactions. The 2005 ISDA Commodity Definitions also contain a number of disruption fallbacks in the event, among other things, a relevant pricing source fails to publish a price or trading on the futures exchange for the underlying commodity is suspended or materially limited. Fallbacks include a calculation agent determination and a no-fault termination under Section 6(e) of the master agreement and postponement of the pricing of the transaction.

Other Considerations

Market participants should also be aware of instances where the fallbacks discussed above may have been amended or deactivated in their agreements (e.g., in master confirmations). Amendments or deactivations may impact certain products generally or could be jurisdiction specific. Investment firms utilizing cross-product and other arbitrage trading strategies should understand any risks associated with certain aspects of the trade behaving differently under disruptive conditions.

OTC derivatives also inherently reference underlying assets which may be independently affected by COVID-19 linked events (such as bonds, loans, ABS securities). Market participants should be aware of default triggers linked to, for example, defaults or ratings downgrades in respect of underlying assets that may carry through to the derivative transaction.

It is also critical that market participants continue to monitor actions and decisions of relevant regulatory bodies and agencies, including with respect to reporting requirements and/or trading restrictions. As of March 16, and for a period of three months thereafter, the European Securities and Markets Authority has lowered the threshold for the reporting of net short positions in shares traded on European markets. Effective immediately, market participants must now report to the relevant national competent authority if the net short position reaches greater than 0.1% (from 0.2%) of the reference entity's issued share capital. Additionally, a number of European countries have renewed temporary bans on short selling altogether in respect of certain issuers' shares (details may be found on the websites of the respective competent authorities for France, Belgium, Spain, and Italy, as of today).

Valuation

Market volatility has been one of the headline stories of the pandemic so far. The extent of the volatility has been more widespread than many would have thought. Not only have the equity markets been impacted, so have typically more stable markets such as the Treasury and overnight repo markets. The results have been the tripping of circuit breakers, government/central bank intervention and significant transfers of value. Significant transfers of value have resulted in operational and liquidity pressures for market participants.

Firms should be cognizant of their margin obligations under their OTC derivatives contracts and consider the availability of cash and/or eligible collateral in the event of significant margin calls in response to continued volatility, in particular because dealers may be less willing to forgive delays or defaults in turbulent markets.

For investment funds, NAV-linked provisions may also be triggered by significant market swings, with potential termination and super-collateralization repercussions.

Notice Delivery

Most OTC derivatives contracts will provide for multiple delivery methods for notices. Typically, ordinary course notices such as margin calls and trade confirmations will be deliverable via email as well as regular mail. However, in certain cases, such as for termination notices, it is possible that delivery via mail or courier may be required. In such cases, parties should be aware of how to deliver notices in the event mail or courier services are suspended and ensure that they are able to monitor receipt of notices that may have adverse consequences, and be in a position to react accordingly. Under the ISDA master agreements, the parties will likely have to attempt to provide notice via any of the notice methods listed in Section 12(a) before they can try to use another method. Parties will probably have to use any such notice methods, even if impractical or inconvenient. It is also possible that some agreements (e.g., master repurchase agreements) may offer more flexibility. Counterparties may consider amending their agreements to address those issues.

Unscheduled Holidays

It is possible that, in response to COVID-19, governments could consider declaring formal public holidays (e.g., the recent extension of the Chinese Lunar New Year in response to COVID-19). Such unscheduled public holidays could result in banking and market closures. Market participants should consider the implications of unscheduled holidays under their various agreements. In particular, firms should be aware of whether they or their counterparties are required to perform on an unscheduled holiday in a particular jurisdiction. For example, in certain emerging markets where unscheduled holidays are viewed as a risk, it may well be that such a holiday would still be considered a business day on which payments and settlements would be required. Counterparties located in those jurisdictions would therefore need to be in a position to perform their obligations notwithstanding the public holiday. In addition, parties should be aware of the impact of a public holiday on interest accrual.

Unscheduled holidays may also impact payment, valuation, and settlement differently across different products. Firms employing arbitrage strategies, for example, should therefore be aware of mismatch risk between different component trades. It is also possible that wide-ranging payment and settlement delays could create liquidity issues at large firms.

Force Majeure

Force Majeure Events in ISDA Documentation

Force majeure provisions typically cover unforeseen events that prevent a party from performing its obligations under a contract. Under the 2002 ISDA Master Agreement (the 2002 Master Agreement), a force majeure constitutes a Termination Event, which will apply only after giving effect to any disruption fallback or other remedy applicable via any relevant definitions (see Market Disruption Events below). The 1992 ISDA Master Agreement (the 1992 Master Agreement) does not contain a force majeure provision but does allow parties to elect an impossibility Termination Event (as discussed below). (Note that the ISDA Illegality/ Force Majeure Protocol also incorporates a force majeure Termination Event into 1992 Master Agreements between adhering parties. However, the protocol has not been widely adopted.)

For a force majeure event to occur under the 2002 Master Agreement, the applicable event must (i) prevent the specific trading office or party from making or receiving a payment or delivery or it becomes impossible or impracticable to do so; (ii) be beyond such office's or party's control; and (iii) be in circumstances in which the office or party must have taken all reasonable efforts to overcome such prevention, impossibility or impracticability (provided the party is not required to incur a material expense). The Termination Event applies prospectively as well in the event prevailing events would make it impossible or impractical for the party to perform its future obligations.

Once a force majeure event is triggered, a waiting period of eight local business days is imposed. During such period, the parties can cure the force majeure event or wait for such event to end. Upon the expiration of the waiting period, if the force majeure has not been resolved, then either party may terminate some or all of the open transactions upon not more than 20 days' notice.

Implications of COVID-19 for Force Majeure Under the 2002 Master Agreement

The force majeure event in the 2002 Master Agreement effectively establishes two tests for an event: (i) the impossibility test and (ii) the impracticability test.

It is unlikely that actions taken to combat COVID-19 would make it impossible for parties to perform their obligations. Impossibility is a very high threshold to meet and generally requires the force of law. For example, a comprehensive shutdown by a government of all payment and settlement systems for an extended period of time would result in an impossibility of performance, but such a scenario is inconceivable, at a minimum, in the initial stages of this pandemic.

On the other hand, impracticability of performance is a lower standard and perhaps something that is more foreseeable. Institutions implementing work-from-home policies or

shutting down offices altogether may make it impractical for a party to perform its obligations. For instance, physically settled transactions may be affected by an office closure due to the COVID-19 outbreak, which although not the result of a force of law, could make settlement impractical.

A force majeure is less likely to arise in the context of non-physically settled transactions as such transactions generally rely on electronic processing. However, national lockdowns, quarantines or other emergency measures may affect the proper functioning of electronic platforms and processing. Presumably, teleworking will allow these transactions to be unaffected and thus not lead to a force majeure under the relevant contract.

In either case, the vast majority of market participants will have plans in place to limit the impact of trading disruptions. In many cases, these plans would provide for alternative processes to facilitate trading activity, even in impractical circumstances. In addition, the broad market disruption fallbacks incorporated into OTC derivatives contracts by asset class-specific definitions (see Market Disruption Events below) and the eight local business day waiting period in the 2002 Master Agreement make for a very high threshold before a force majeure event occurs. For example, any action taken that creates performance impracticability would need to be in place for a significant period of time and would need to make it impracticable to utilize all available fallbacks (which would likely include cash settlement) as well. It is therefore unlikely that COVID-19 related actions would result in a force majeure event.

1992 Master Agreement Impossibility Event

The 1992 Master Agreement does not contain a force majeure event; however, market participants may elect Impossibility as an Additional Termination Event per the impossibility provision in the User's Guide to the 1992 Master Agreement. Such event would be subject to the heightened standard discussed above and it is therefore unlikely to be triggered.

Frustration and Temporary Impossibility

In addition to the contractual terms in the 2002 Master Agreement and 1992 Master Agreement, contracts governed by English law would also be subject to the English law concept of Frustration. This concept is not dissimilar from a force majeure event in that a party seeking to rely on such argument would need to show that events since the contract was entered into have resulted in performance becoming impossible or so onerous that it would no longer be reasonable to expect the party to perform. As with the force majeure event, the bar is very high and it appears unlikely COVID-19 would satisfy that standard.

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