

COVID-19 Derivatives Checklist – Part 2: Potential issues and action items on certain OTC products

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The novel coronavirus (**COVID-19**) pandemic is presenting the global markets with unprecedented challenges. Governments, corporations and the financial markets have been struggling to evaluate and adapt to the social and economic impact of COVID-19. We have created this three-part Client Alert to highlight some issues and considerations which, though general in nature and not intended to be exhaustive, we hope will be helpful as part of your preparations for the unique challenges ahead.

In Part 1, we discussed the key legal and practical issues that market participants should consider under the ISDA Master Agreement and related ISDA collateral agreements. In this Part 2, we discuss the issues as applied to certain over-the-counter (**OTC**) derivatives products. In Part 3, we will discuss recent derivatives regulatory issues.

General

- Market participants should evaluate their transaction terms in light of - and in anticipation of - COVID-19-related market disruptions and volatility, including government interventions in the relevant jurisdictions.
- **Trading Market Suspensions.** Monitor suspensions, disruptions and partial or complete closures of relevant markets and exchanges. Recent market sell-offs have triggered temporary circuit breakers and trading suspensions in a number of exchanges (e.g., [Philippine Stock Exchange's recent trading suspension](#)).
- **Unanticipated Holidays.** Review the correlation between banking day, business day, exchange business day and other business day definitions, as applicable, to determine how unanticipated closures of certain markets may affect the performance, valuation, settlement and other aspects of transactions. Global efforts to contain the pandemic through mass quarantine may lead to more unanticipated holidays (e.g., [China's extension of the Lunar New Year holiday to February 2 \(from January 30\) to contain the COVID-19 outbreak](#)).
- **Government Interventions.** Monitor and evaluate government intervention and remedial measures in the relevant jurisdictions. As the adverse impact on the global economy increases, more jurisdictions may employ remedial measures that disrupt the normal operation of the derivatives markets (e.g., [Autorite des Marches Financiers' temporary prohibition on short sales announced on March 14, 2020](#)).

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- **Market Volatilities and Collateral Management.** Monitor and access market fluctuations and their impact on collateral posting requirements.

Commodity Derivatives

- Monitor potential disruption events and fallbacks. Commodity derivatives may be particularly sensitive to temporary market closures and physical delivery disruptions. This may give rise to postponement in valuation and/or settlement, calculation agent determinations on value and/or early termination.

Equity Derivatives

- Check documentation for adjustment events, extraordinary events or other similar triggers that would allow a party or calculation agent to adjust transaction terms and/or terminate transactions.
 - Monitor relevant markets for prolonged trading disruptions or suspensions (e.g., exchange market closings) which may lead to hedging disruption, increased cost of hedging, loss of stock borrow, increased cost of stock borrow or other similar events.
 - Anticipate and evaluate regulatory interventions that may be interpreted as disruption or illegality events (e.g., short sale bans).
- Consider sensitivity of transactions to intraday disruptions and early closures in the relevant trading markets, which may exclude an otherwise scheduled trading day from being counted for purposes of valuation, exercise (in the case of options) and/or settlement purposes (e.g., [Nasdaq instituted 15-minute trading halt on March 18, 2020](#)).
- Review price-related triggers of transactions (e.g., knock-in, knock-out or strike price), as high volatility and market movements may activate premature settlements or terminations.

Credit Derivatives

- Monitor and evaluate potential governmental interventions that may delay occurrence of credit events. Global governments have been increasing their efforts to soften the adverse impact of the current pandemic on the economy. This may take the form of liquidity lines, direct stimulus and/or relaxation of regulations (e.g., [Germany preparing regulation to suspend insolvency filing obligations for companies affected by the COVID-19 pandemic](#)).

Rate and Foreign Exchange Derivatives

- Evaluate the effect of unanticipated holiday and temporary bank and/or market closures on the timing of valuation, payment and settlement. For example, business days are typically tied to banking days, which may be subject to different emergency closures from other financial markets within the same jurisdiction, resulting in ambiguity of payment timing and potential mismatch of component hedging (e.g., [Suspension of BAP Spot USD/PHP trading in Philippine on March 17, 2020, despite commercial banks being generally open](#)).

Cleared Transactions

- Engage with clearing member(s) (or clearinghouses for clearing members or futures commission merchants) regarding exposure limits and any calibration or collateral concentration issues around current and future anticipated margin calls.
- Clearing members or futures commission merchants should reassess their client margin multipliers and buffers and ensure that their clearinghouse fire drill contact details are up to date and their relevant traders are ready to help their clearinghouses hedge a defaulter's portfolio prior to any default auction.

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