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THE FAT TAIL REPORTER

ROLLING DOWN THE CURVE

Message from the Editors

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INTRODUCING *THE FAT TAIL REPORTER*

Before the financial crisis began to unfold in 2007, little thought was given to the ramifications of being a "systemically important financial institution" or "major swap participant" or of engaging in transactions with "covered banking entities." Now, with the regulatory foundation shifting beneath our feet, these terms and dozens of others have become part of our daily lives. As regulators scramble to implement the 2,300-page framework of financial reforms informally known as "Dodd-Frank" within the ambitious time frames mandated by the statute—and in an election year, no less—it is increasingly difficult to sift through the various issues and determine what, if anything, is relevant to your business. It is with financial reform and its far-reaching implications in mind that we are pleased to present the inaugural edition of ***The Fat Tail Reporter***. We seek to cover a range of issues relevant to all market participants, with a particular focus on those firms that utilize derivatives as part of their business, as well as the banking entities that are directly affected by the sweeping regulatory changes.

This edition showcases the many ways in which Jones Day services the structured and derivatives products industry. From the Banking & Finance Practice, we have articles discussing the issues surrounding the cross-margining of cleared and uncleared derivatives and calculation agent dispute rights. From the Financial

Institutions Litigation & Regulation Practice, we offer a piece on the recent decision from the English Court of Appeals addressing the impact of Section 2(a)(iii) of the ISDA Master Agreement following an event of default by one of the parties. From the Tax Practice, we have a review of new regulations proposed by the IRS pursuant to the Foreign Account Tax Compliance Act that affect many market participants, including non-U.S. investment funds.

In addition, we would like to welcome our newest colleague, Ilene Froom, who recently joined our New York Office as a partner. Ilene concentrates her practice on equity derivatives and brings with her a wealth of knowledge and experience that will greatly enhance our ability to address all of our clients' needs. Prior to joining Jones Day, Ilene worked at a global derivatives dealer where she focused on all types of onshore and offshore equity derivatives transactions. Ilene is active in the various ISDA committees dealing with equity derivatives and was heavily involved in the drafting of both the 2002 ISDA Equity Definitions and the 2011 ISDA Equity Definitions.

We hope you find ***The Fat Tail Reporter*** useful and informative, and we invite you to reach out to us with questions or suggestions for future topics that are relevant to you. We are also looking forward to the ISDA Annual General Meeting in Chicago. There will be a strong Jones Day contingent representing both our U.S. and international offices, and we hope to see you there.

—The Editors

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INDUSTRY UPDATES

MANDATORY CLEARING AND CROSS-MARGINING

One of the most important market reforms that will be implemented pursuant to the Dodd-Frank Act is the requirement that participants in the over-the-counter ("OTC") derivatives markets clear certain types of trades with a central counterparty ("CCP"). Clearing effectively replaces a single bilateral trade with two new offsetting trades where the CCP acts as the counterparty to each of the original parties. Once a trade is cleared, the parties to the original bilateral trade no longer face each other. In this way, the insertion of a CCP mitigates the risk of nonperformance by one of the parties during the trade (also known as "counterparty risk") by effectively having the CCP ensure performance by the parties. Instead of each party being at risk to the other for the length of the trade, they both have recourse to the CCP, so that if one of the parties defaults, the other will not lose any amount that it is otherwise owed under that contract.

This so-called "clearing solution" is one that took hold in the wake of the Lehman bankruptcy. Following the Lehman default, market participants were concerned that the default of Lehman would cause other major market participants to default, given that the OTC derivatives markets were highly interconnected. Since many OTC market participants typically hedge their risk with other OTC derivatives, the fear was that a single default could cause a chain reaction of nonperformance or "cascading" defaults. In response to Lehman, regulators seized on the idea of interposing the CCP into the relationship, effectively substituting the bilateral credit risk of the various dealers for a single, centralized hub. A CCP (i) nets offsetting exposures, (ii) calls for and monitors collateral, and (iii) ultimately manages any defaults of its members. Additionally, the CCP will act as a guarantor for every trade, allowing for better reporting and monitoring of the markets. In short, the view that the overall risk to the system arising from any counterparty default is reduced by clearing caught on quickly and has remained at the forefront of the global regulatory reform effort. In the United States, the passage of Dodd-Frank mandated the clearing requirement and set the regulators to the task of figuring out how to prudently manage this new system.

DODD-FRANK AND THE CLEARING MANDATE

The threshold test for mandatory clearing under Dodd-Frank is that a CCP has to accept that type of OTC derivative for clearing before it will be required to be cleared. Currently, the market expects that the initial group of trades required to be cleared will include the most liquid single-name and index credit default swaps ("CDS"), along with the most commonly traded forms of interest rate swaps, such as USD, GBP, and EUR fixed/floating swaps in maturities out to 30+ years. However, certain types of derivatives are not expected to be available for clearing in the near term, including products such as swaptions and CDS tranches; certain types of derivatives that are more customized may never be subject to mandatory clearing because they are too specific to be matched up with an offsetting contract. As a result, the current expectation is that once clearing becomes mandatory, many firms will find themselves with portfolios that are split between cleared and uncleared derivatives.

As the market prepares to meet the mandatory clearing requirement under Dodd-Frank, certain questions have begun to emerge about how clearing will work in practice. In particular, firms that trade multiple asset classes within the OTC derivatives markets are starting to examine the impact of taking their cleared trades out of what was previously a single portfolio. Many firms currently use cross-margining, which allows them to realize a significant economic savings. However, the final rules on the treatment of cleared swap customer collateral, as adopted by the Commodity Futures Trading Commission ("CFTC") in January, have caused the market to question whether cross-margining will be available between cleared and uncleared swaps.[1]

Under the final and proposed rules for both cleared and uncleared derivatives, there will be mandatory initial margin requirements associated with each of these types of trades. Separate proposals on margin requirements for uncleared swaps by the five U.S. prudential regulators, as well as the CFTC and, for security-based swaps, the Securities and Exchange Commission, may restrict how margin can be used by limiting the ability to apply portfolio offsets between certain broad categories of risk.[2] That is, a party that had posted excess margin for one category of swap could not use that excess margin to reduce its margin requirements for another swap category. In the prudential regulators' proposals, these categories are commodity, credit, equity, and foreign exchange/interest rate swaps. In addition, the proposals do not appear to contemplate margining across swap and security-based swap transactions, and between other transactions excluded from the definition of "swap" (for example, repurchase transactions, securities lending transactions, or foreign exchange swaps and forwards that are excluded from the definition of a swap). These restrictions on cross-margining could also significantly increase the costs of risk-reducing swaps activity by significantly increasing the margin required for all derivatives, thereby discouraging participants from hedging with swaps, and in turn making the overall markets less liquid. Therefore, the move to mandatory clearing is potentially an expensive one for customers who currently enjoy the benefits of a single portfolio of OTC derivatives.

CROSS-MARGINING

In this context, cross-margining is a legal arrangement where a dealer looks at its uncleared trades with a customer, then takes into account other opposite or offsetting cleared derivatives and futures trades held by the futures commission merchant affiliate of the dealer. This allows the dealer to calculate a net risk figure that reduces the customer's initial margin requirements for uncleared swaps. Whether or not this type of cross-margining is permissible is a fundamentally important issue for market participants.

Given the potential scarcity of eligible collateral, and the fact that some market participants have never had to post initial margin before, getting clear regulatory guidance is critical to all market participants. Currently, customers are able to agree to some form of customer margining with their clearing members, where the risk of the customer's cleared and uncleared portfolios with that clearing member and its affiliates are viewed on an aggregate basis. As a result, a

1 77 Fed. Reg. 6336 (Feb 7, 2012), Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, *available at*: http://cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-1033a.pdf.

2 The "Prudential Regulators" are the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Farm Credit Administration, and the Federal Housing Finance Agency. Both the Prudential Regulators and the CFTC have proposed margin requirements for uncleared swaps.

net initial margin figure can be calculated that is lower than the initial margin that would be separately required on the cleared and uncleared positions.

In theory, cross-margining between cleared and uncleared trades is straightforward. The complexity lies in the fact that the two portfolios are likely to reside in different (albeit affiliated) legal entities subject to different regulatory regimes. As an example, if a customer has a portfolio of uncleared swaptions with a dealer and another separate portfolio of cleared interest rate swaps with the dealer's FCM affiliate—with the swaps positions offsetting the delta on the swaptions—the net initial margin required based on the risk of the combined portfolio would be lower if cross-margining is permitted than would be the case if each portfolio were considered separately. For example, treated separately, the CCP might call for $50 million of margin on cleared swaps, while the uncleared swaptions might require $100 million. However, after giving effect to cross-margining, on a net basis, the total margin required to cover both portfolios, based on the composite risk, might be only $80 million. There would be no reduction to the amount of initial margin required for the portfolio of cleared swaps, but the dealer holding the swaptions positions, knowing that $50 million had been posted to the CCP via its FCM, might need to call for only an additional $30 million to cover the uncleared portfolio. Whether each of the relevant regulators will permit this arrangement and how this reduction will be recognized in terms of the dealer's risk management requirements, including regulatory capital treatment, is still an open question.

PRACTICAL CONCERNS EMERGE

In adopting the "legal segregation, operational commingling" ("LSOC") model, the CFTC stated, "While the Commission supports the benefits of portfolio margining, the Commission does not believe it would be prudent to permit collateral margining cleared positions to simultaneously be used to margin uncleared positions."[3] Consequently, those firms that have cross-margining arrangements in place today, or that had not been previously required to post initial margin, would be wise to consider the impact of initial margin requirements when clearing is required.

This statement appears to arise due to an incorrect assumption, i.e., that the CFTC believes that in order for cross-margining to work, collateral pledged to support cleared transactions must be double-counted and allowed to be deemed to support uncleared trades. While cleared customer collateral should not be double-counted in any case, under a cross-margining arrangement, cleared customer collateral is not being "used to margin uncleared positions." Rather, cross-margining allows net initial margin calculations to be based on the overall risk of the portfolio, taking into account the required cleared customer collateral and then potentially allowing for a corresponding reduction in uncleared customer collateral. In each case, the aggregate amount of margin will at all times be sufficient for the level of risk when calculated on a portfolio basis.

CONCLUSION

On a portfolio basis, the margin proposals for both cleared and uncleared swaps will result in much higher margin requirements for all market participants. The Office of the Comptroller of the Currency has estimated the initial margin requirement for uncleared swaps could be as high as $2.05 trillion.[4] While these numbers are highly preliminary and necessarily based on assumptions about the split between cleared and uncleared derivatives marketwide, there is no doubt that funding costs associated with initial margin requirements will increase significantly. In this environment, it becomes very important for market participants to be appropriately margined for their risk, taking into account all of the positions in a participant's book, and viewing the risk holistically. In our view, cross-margining incentivizes risk reduction through hedging and the maintenance of balanced portfolios; allows capital to be deployed most efficiently, yielding better returns for the investing public; and facilitates the transition to central clearing. Obtaining legal certainty

3 While the term "swap" is defined in Section 721(a)(47) of the Dodd-Frank Act, the CFTC has not yet issued its final rule defining that term. However, we assume for purposes of the clearing mandate that the term "swap" will encompass almost all transactions commonly known as over-the-counter derivatives.

4 OCC study, "Unfunded Mandates Reform Act, Impact Analysis for Swaps Margin and Capital Rule," dated April 15, 2011 ("OCC Study"), *available at*: http://www.regulations.gov/#!documentDetail;D=OCC-2011-0008-0002, pp. 5 - 6.

and regulatory approval for cross-margining of cleared and uncleared OTC derivatives will be a critical part of this equation.

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CALCULATION DISPUTE RESOLUTION PROCEDURE: A NEW DETAILED PROCESS FOR DISPUTE RESOLUTION

In July 2011, ISDA published the 2011 ISDA Equity Derivatives Definitions (the "2011 Definitions").[1] Within this publication is an entire Article, numbered 22, devoted solely to the "Calculation Dispute Resolution Procedure." At just over 15 pages in length and including additional terms that are defined elsewhere in the 2011 Definitions but that are used in this Article, one might wonder how a provision on the Calculation Agent dispute process takes up so much space. The answer is that there are many facets of and details as to how a Calculation Dispute Resolution Procedure can work. The role of the Calculation Agent is critical, as it is the party that makes determinations under transactions, such as adjustments for corporate events and how much money one party owes the other on one or more payment dates.

Which party is the Calculation Agent and whether or not that role is subject to dispute rights by the other party are questions that may be answered in a variety of ways in different forms of ISDA documentation. Dispute rights may be included in a confirmation governing a single transaction. They may also be included in master confirmations that govern certain types of trades, such as equity swaps. Sometimes dispute rights are embedded in the Schedule to the ISDA Master Agreement, where such rights may apply to all, or only certain, transactions entered into thereunder, and may apply differently to different asset classes. The Credit Support Annex to the ISDA Master Agreement has its own dispute resolution process that a party can invoke if it disagrees with the Valuation Agent's determination of the value of collateral and/or how much collateral should be delivered or returned.

It is not only the location of dispute right provisions that varies, but the content and mechanics of the language and process. A dispute resolution provision may say no more than "determinations by the Calculation Agent are subject to agreement by the parties" or something to this effect. This leaves open the question of how long a party has to dispute a determination if the Calculation Agent didn't seek such party's agreement to the Calculation Agent's determination. Could the other party dispute in a week, in a month, in two months? A trade can have a single payment that isn't determined until years after the trade date. A provision may say that if the parties don't agree on the Calculation Agent's determination, they will pick a third-party dealer to resolve the matter. How long the parties have to agree on that third-party dealer and what happens if the parties do not agree is not always addressed.

Payment and delivery obligations under an OTC derivatives transaction can be significant. Having a clear and detailed dispute resolution process govern a transaction can mitigate issues associated with more open language. Article 22 of the 2011 Definitions contains such detailed provisions that can be incorporated into an over-the-counter equity derivatives transaction that incorporates the 2011 Definitions.

The Calculation Dispute Resolution Procedure in the 2011 Definitions contains hard-coded definitions and processes but also permits parties to make certain choices and to define certain methodologies in the future. For example, a party may initiate the dispute process only by notifying the Calculation Agent on or prior to the "Dispute Notice Deadline." This deadline may be determined (i) in accordance with a "Date Selection Methodology for Dispute Notice Deadline Dates," (ii) as an agreed number of days by the parties (e.g., two Reference Days after the Calculation Agent's effective notice to the other party of its determination), or (iii) by using the fallback in the 2011 Definitions, which is the third Reference Day after the Calculation Agent's effective notice to the other party of its determination.

Parties also have a choice of how much should get paid or delivered prior to the dispute being resolved. There are

1 Capitalized terms used herein and not otherwise defined or used in the ISDA Master Agreement have the meaning set forth in the 2011 Definitions.

timelines for initiating a dispute, selecting third-party dealers, and when dealers that have been appointed must respond with a determination. Depending on how the relevant deadlines are defined, it could take a week or two (or more or less) until a dispute is resolved. The 2011 Definitions provide different alternatives that allow the parties to select how much a party should pay or deliver when the original payment or delivery is due. These are Payment/Delivery of Undisputed Amount Only, Payment/Delivery of Original Amount, Payment/Delivery of Half Disputed Amount, and Escrow of Disputed Amount.

Parties using the Calculation Dispute Resolution Procedure need to be cognizant of how these provisions work and what elections they are entitled to discuss and agree to with the other party. Some of the issues are as follows:

- Do parties want the dispute process to be anonymous?
- Should the determinations of the dealers polled be used to resolve the dispute or should there be a determination by the polled dealers as to whether or not the Calculation Agent's determination was commercially reasonable?
- What happens to the dispute resolution process if the disputing party is in default?
- What if not every dealer polled replies by the relevant deadline? In that case, depending on the type of determination, if only one or two dealers polled so reply, the result will depend on whether the parties have agreed that the "Minimum Number of Responders" would be one or two.
- What happens with mathematical determinations that can be averaged? This will depend on how many of the dealers polled respond by the relevant deadline, the agreed Minimum Number of Responders, and whether or not Dealer Poll was agreed. For example, if the four dealers polled respond by the relevant deadline, the Minimum Number of Responders is two, and Dealer Poll is specified, the determination will be the arithmetic mean of the two numbers that remain after removing the highest and lowest numbers.

Although the Calculation Dispute Resolution Procedure is part of the 2011 Definitions, ISDA is expected to publish a bridge so that parties can use its provisions in over-the-counter equity derivatives transactions that incorporate the 2002 ISDA Equity Derivatives Definitions. The Calculation Dispute Resolution Procedure contains valuable tools that can be used in documentation for other types of OTC derivatives transactions. There might be a benefit to the market having a consistent framework for settling disputes that a party has with the Calculation Agent for a transaction, although parties may make certain modifications to reflect differences among the asset classes. Time will tell whether or not the market will adopt some or all of the language in the 2011 Definitions beyond the scope of OTC equity derivatives transactions.

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CLARIFYING THE USE OF SECTION 2(A)(III) OF THE ISDA MASTER AGREEMENT

On April 3, 2012, the English Court of Appeal handed down[1] its highly anticipated judgment in four separate matters, all of which concerned the consequences of an Event of Default and the impact of Section 2(a)(iii) under the ISDA Master Agreement. All four appeals primarily focused on the 1992 version of the ISDA Master Agreement, but the Court of Appeal's reasoning and decision applies equally to the 2002 version.

SECTION 2(A)(III) OF THE ISDA MASTER AGREEMENT

Section 2(a)(iii) of the ISDA Master Agreement is stated to be a condition precedent to any payment and delivery obligations arising out of transactions governed by the ISDA Master Agreement. If an Event of Default or Potential Event of Default has occurred and is continuing, the stated effect of Section 2(a)(iii) is that the nondefaulting party does not have to make any payments or deliveries due to the defaulting party under the agreement.

1 [2012] EWCA Civ 419. In the appeal of (i) *Lomas and others (together the Joint Administrators of Lehman Brothers International (Europe) (in administration)) v. JFB Firth Rixson, Inc and others and ISDA as intervenor; (ii) Lehman Brothers Special Financing Inc v. Carlton Communications Ltd; (iii) Pioneer Freight Futures Company Ltd. v. Cosco Bulk Carrier Company Ltd; and (iv) Britannia Bulk plc v. Bulk Trading SA.*

The precise legal effect of Section 2(a)(iii) has been a controversial area over the last few years. Differing judicial interpretations had emerged in earlier English litigation on key issues such as whether obligations suspended by Section 2(a)(iii) were extinguished once the transactions had passed their final payment date. In the same period, the United States Bankruptcy Court for the Southern District of New York held (in the *Metavante* proceedings) that a counterparty could not rely on Section 2(a)(iii) and the safe harbor provisions in the Bankruptcy Code indefinitely to excuse a failure to perform obligations under a swap agreement with an insolvent counterparty.

The Court of Appeal's unanimous decision brings significant clarity on Section 2(a)(iii) from the English law perspective. It is important to note, however, that the judgment does not address the potential impact of non-English law or procedure (particularly foreign insolvency law) on Section 2(a)(iii), notwithstanding that a relevant ISDA Master Agreement is governed by English law.

The four cases under consideration by the Court of Appeal were (1) *Lomas v. Firth Rixon*, which arose out of the administration of *Lehman Brothers International (Europe)*, (2) *LBSF v. Carlton*, which arose out of the entry by LBSF into Chapter 11 bankruptcy proceedings in the U.S., (3) *Pioneer v. Cosco*, which involved 11 forward freight agreements subject to the 2007 terms of the Forward Freight Agreement Brokers Association (FFBA 2007), incorporating the 1992 version of the ISDA Master Agreement by reference; and (4) *Bulk v. Britannia Bulk*, again involving a forward freight agreement on FFBA 2007 terms.

KEY FINDINGS BY THE COURT OF APPEAL

Section 2(a)(iii) Does Not Prevent Payment or Delivery Obligations from Coming Into Existence Under the ISDA Master Agreement. One of the first questions resolved by the Court of Appeal is whether payment or delivery obligations even come into existence at any time after an Event of Default (or Potential Event of Default) has occurred. It was suggested in earlier proceedings that they did not, based on the wording of Section 2(a)(iii).

The Court of Appeal noted when reviewing the overall structure of the ISDA Master Agreement that any payment obligation always has a corresponding debt obligation, meaning that the duty to make a payment arises from a party owing an amount to the other party. According to the court, these are two distinct obligations; the suspension of the obligation to pay under Section 2(a)(iii) does not affect the underlying amounts owed, or any other obligations that subsequently come due following suspension of payments pursuant to Section 2(a)(iii). As a result, following the nondefaulting party's election to invoke Section 2(a)(iii), any additional amounts that accrue during the suspension of payments will come due when payments are again required to be made, i.e., when the Event of Default is cured or when the underlying Transactions are terminated.

Section 2(a)(iii) Suspends Payment or Delivery Obligations, It Does Not Extinguish Them. Following logically from the previous finding, the Court of Appeal held that the payment obligations of a nondefaulting party are suspended during the period of an Event of Default under the ISDA Master Agreement. However, these obligations are not extinguished and will revive if the Event of Default is cured at any time before the underlying Transactions are terminated.

The Payment Obligations Cannot Be Revived Other Than by Curing the Event of Default. The Court of Appeal considered a number of implied terms that would have the effect of reviving the suspended payment obligations without the Event of Default having been cured. For example, one suggested implied term would have disapplied Section 2(a)(iii) after a "reasonable time" had elapsed following the occurrence of an Event of Default, on the basis of a similar reasoning to Judge Peck's decision in *Metavante*. Other suggestions included disapplying Section 2(a)(iii) upon the maturity of all relevant transactions, or after such time as required to elect for early termination and effect closeout netting under the ISDA Master Agreement.

None of the implied terms was accepted by the Court of Appeal. The test under English law for reading implied terms into a contract requires that the implication is "necessary" or "obvious" to any disinterested third party such that the contract must have the meaning that the implied terms would give it. The court concluded that none of the suggested terms was necessary or required to this standard. As a result, Section 2(a)(iii) under English law can suspend payment

obligations under the ISDA Master Agreement potentially indefinitely.

Suspended Payment Obligations Are Also Not Extinguished On Maturity. Various earlier English decisions had held that payment obligations suspended by Section 2(a)(iii) would be entirely extinguished once the transactions had passed their final payment date (and therefore could not be revived in the event that the Event of Default was subsequently cured).

In line with ISDA's submissions as intervenor on these issues, the Court of Appeal rejected this analysis, on the basis that it was simply not supported by the express terms of the ISDA Master Agreement and there was no need to read an implied term into the contract to give this effect. The court concluded that any suspended payment obligation is not extinguished on the maturity of the underlying transaction and noted that it would still be possible for the nondefaulting party to terminate "early" after maturity, if they wished to do so. If the nondefaulting party does not wish to do so, it must accept the consequence of the contractual obligations continuing to exist (i.e., the possibility that the Event of Default will be cured and the suspended payment obligations will revive).

Gross vs. Net Claims. The Court of Appeal considered two conflicting, earlier English decisions on the question of whether a nondefaulting party is entitled to payment of the gross obligations of the defaulting party, without being required to net against any outstanding obligations of the nondefaulting party. Previous decisions had suggested that netting under Section 2(c) would be available only where Section 2(a)(iii) is not in play, i.e., where the nondefaulting party is not entitled to suspend payments.

The Court of Appeal rejected this view and determined that Section 2(c) remains applicable in circumstances where the nondefaulting party relies on Section 2(a)(iii).

However, the court also noted that the netting provisions in Section 2(c) apply only to amounts that, under the terms of the original agreement, are expressed to be payable on the same date and with respect to the same transaction.

Section 2(a)(iii) Does Not Offend the Anti-Deprivation Principle. The anti-deprivation principle is a fundamental tenet of English insolvency law. It is based on the principle that a party cannot contract out of the statutory requirement that assets owed at the date of liquidation should be available to the liquidator to meet the claims of the estate's creditors.

The Court of Appeal concluded that the suspensory nature of Section 2(a)(iii) did not offend this principle and that the anti-deprivation rule was directed toward intentional or inevitable evasion of the principle that a debtor's property is part of the insolvent estate. The suspension of the payment obligations of the nondefaulting party for the duration of the insolvency appeared to the Court of Appeal only to prevent the nondefaulting party from having to make payments under a swap agreement with a bankrupt counterparty. Given the history of Section 2(a)(iii) as a standard ISDA clause, the court concluded it did not meet the requirement of having been formulated in order to avoid the effect of any insolvency law or to give the nondefaulting party a greater or disproportionate return as a creditor of the bankrupt estate.

CONCLUSION

The Court of Appeal's decision has clarified a number of key issues relating to Section 2(a)(iii), and the decision that suspended obligations are not extinguished on maturity has been welcomed by market participants. The decision will also be relevant to the current ISDA consultation on changes to the ISDA Master Agreement (and particularly the proposed curtailment of a counterparty's entitlement to rely on Section 2(a)(iii) indefinitely). In the United Kingdom, H.M. Treasury ("HMT") has taken the view that payments due to insolvent counterparties should not be withheld indefinitely due to the level of uncertainty and adverse impact on unsecured creditors of bankrupt entities. HMT has suggested it may look to effect a statutory solution to this issue if a market-based solution does not emerge in the near future.

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FATCA PROPOSED REGULATIONS: DEADLINES EASED BUT THE SYSTEM MOVES FORWARD

On February 8, 2012, the IRS released proposed regulations[1] on the Foreign Account Tax Compliance Act ("FATCA"), which was enacted in 2010.[2] FATCA imposes obligations on U.S. taxpayers and withholding agents, as well as certain foreign entities. Under the FATCA regime, U.S. taxpayers that hold foreign financial assets with an aggregate value of more than $50,000 will have to file a disclosure on Form 8938 with the IRS. Moreover, certain foreign financial institutions ("FFIs") will have to enter into an agreement with the IRS under which they will take on reporting and withholding obligations. If an FFI is required to enter into an agreement with the IRS, it must do so prior to July 1, 2013 in order to avoid withholding on U.S.-source payments made in 2014 and thereafter, and must report information with respect to U.S. holders of accounts beginning in 2014.

FFIs for FATCA purposes include both foreign banks and investment vehicles such as hedge funds, private equity funds, CLOs, and CDOs. It is likely that these entities will meet the definition of an FFI despite some exceptions provided by the new proposed regulations that are discussed below. As a result, beginning in 2014, any U.S.-source payment made to an FFI on its assets—such as a payment of interest or original issue discount ("OID") on a U.S. debt obligation—will be subject to this 30 percent U.S. withholding tax unless the FFI enters into an agreement with the IRS. Withholding on gross proceeds of a sale or other disposition of these assets by an FFI is required starting in 2015.

No withholding is required on payments on obligations entered into before the FATCA regime's effectiveness. Perhaps the best news in the proposed regulations is the extension of such "grandfathered" treatment to U.S. obligations entered into prior to January 1, 2013 (previously this was March 18, 2012). This means that a payment made to an FFI on an instrument entered into in 2012 will never be subject to withholding under the FATCA rules. The only qualification is that if the instrument is subsequently modified in a manner that causes it to be treated as a new instrument for tax purposes, the grandfathered treatment is lost.[3] The proposed regulations also provide a helpful clarification that payments on a derivative transaction entered into under an ISDA Master Agreement in 2012 or earlier are similarly grandfathered. In preparation for 2013, some parties have started to add FATCA provisions to their ISDA Master Agreements. Additionally, ISDA may publish a FATCA Protocol to address these requirements.

The required IRS agreement will obligate the FFI, among other things, to (i) obtain information necessary to determine which of the holders of its accounts or securities (including equity and debt) are U.S. persons, (ii) report annually to the IRS the name, Social Security number, or taxpayer identification number ("TIN"), and investment amount of each of these U.S. investors, and (iii) deduct and withhold 30 percent from any payment it makes either to U.S. investors or other FFIs that do not themselves comply with these provisions.

The proposed regulations reduce somewhat the amount of information that an FFI must report with respect to U.S. investors under the IRS agreement. For tax years 2014 and 2015 (i.e., reporting with respect to the 2013 and 2014 years), what must be reported is the U.S. investor's name, address, TIN, account number, and account balance. Starting in 2016 (with respect to the 2015 year), all of the statutory reporting requirements, including the income allocable to the U.S. investor from the FFI, become applicable. For determining who are the U.S. investors, the proposed regulations contain favorable rules as to the "due diligence" required by the FFI. For example, for existing accounts of individuals with a balance of $1 million or less, the FFI needs to review only electronically searchable data in order to find evidence of U.S. status. Existing accounts of entities with a balance of $250,000 or less are entirely exempt from review until the account balance exceeds $1 million, and above that, the FFI can generally rely on anti-money-laundering/know-your-customer ("AML/KYC") records and other existing account information for U.S. status. Although the rules for new accounts are more complex, the ability generally to rely on data

1 Proposed Treasury Regulations § 1.1471-1 et seq.

2 Internal Revenue Code §§ 1471-1474, added by the Hiring Incentives to Restore Employment ("HIRE") Act of 2010, P.L. 111-147.

3 See Treas. Regs. § 1.1001-3.

already obtained by the FFI, including AML/KYC data, was a pleasant surprise to many tax practitioners.

Some relief is provided with respect to other deadlines as well. An FFI is required to withhold 30 percent on U.S.-source payments made to investors in two situations: (i) when an investor is determined to be a U.S. investor but refuses to give the FFI the required information, and (ii) when the investor is another FFI that has not entered into the required agreement with the IRS. With respect to U.S.-source amounts that the FFI pays to such investors, such as interest and OID on U.S. obligations, the withholding obligation starts on January 1, 2014 (and January 1, 2015 with respect to payments of gross proceeds). With respect to other "pass-through" payments—indirect U.S.-source payments to the investor resulting from the FFI's investment in other entities—the proposed regulations defer the withholding obligation until January 1, 2017. (This deferral comes as a relief to many FFIs because earlier IRS announcements had indicated that the withholding amount would be determined on a straight percentage basis according to the FFI's U.S. assets, direct and indirect.) The FFI must make an annual report to the IRS of the payments withheld.

Many in the investment fund community hoped that the proposed regulations might exclude certain types of non-U.S. funds entirely from the FATCA rules. Unfortunately, this turned out not to be the case. There are two exceptions that relate to non-U.S. funds. These exceptions have different requirements, but for each of them, the fund must be regulated as an investment fund in its country of organization. Thus, for many, if not most, non-U.S. funds, the FATCA rules above will be fully applicable, with the proposed regulations providing help only on the deadlines and other matters above.

Public comments on the proposed regulations may be submitted until April 30, 2012, and a hearing is scheduled for May 15, 2012. It seems unlikely that there will be major changes when the regulations are issued in final form, including with respect to the deadlines. Nevertheless, the market will know for sure only when the final regulations are published.

For a more detailed analysis of FATCA, please see our White Paper: "Treasury Issues Proposed Regulations on the Information Reporting and Withholding Tax Provisions of FATCA," available at: http://www.jonesday.com/treasury_issues_proposed_regulations_fatca.

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AT THE WIRE

Recent Items of Interest That Were Still Developing as We Went to Press

- **FED CLARIFIES IMPLEMENTATION DATE FOR VOLCKER RULE (April 19, 2012)**

The Board of Governors of the Federal Reserve System (the "Fed") announced its approval of a statement clarifying that an entity covered by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Volcker Rule") has the full two-year period provided by the statute to fully conform its activities and investments, unless the Fed further extends the conformance period. The Volcker Rule, enacted as part of the Dodd-Frank Act, imposes broad restrictions on proprietary trading and sponsoring and investing in private funds by banking entities. In an intra-agency statement, the Fed, OCC, FDIC, SEC, and CFTC stated that they will administer their oversight of banking entities under their respective jurisdictions in accordance with the Fed's conformance rule. These agencies have invited public comment on a proposal to implement the Volcker Rule but have not yet adopted a final rule. Due to the inherent complexity of the proposal and the thousands of comment letters submitted in response to the proposal itself, several of these agencies have stated publicly that the final implementing rules may not be issued before July 21, 2012, which is the statutory effective date for the Volcker Rule. With this date fast approaching, the regulators felt it prudent to publicly confirm that the two-year conformance period will apply (at a minimum) to regulated banking entities. Notwithstanding this helpful clarification, even with this two-year conformance period, it remains a vexing question as to how banking entities can conform their activities to a yet-to-be-finalized rule.

CFTC FINALIZES SWAP DEALER/MAJOR SWAP PARTICIPANT DEFINITIONS (April 18, 2012)

The CFTC voted 4-to-1 on April 18, 2012 to approve its final rule outlining the definitions of "swap dealers" and "major swap participants." The SEC also approved its final rule on the definition of "security-based swap" and "major security-based swap participant." While these final rules have not been published as of this writing, it appears that a "swap dealer" will be an entity that (i) holds itself out as a dealer in swaps, (ii) makes a market in swaps, (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account, or (iv) engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps. There will be a ***de minimis*** exception from dealer status during an initial phase-in period for entities that engage in swap dealing where the aggregate effective notional amount, measured on a gross basis, of the swaps that the person enters into over the previous 12 months in connection with dealing activities does not exceed $8 billion. (The exception threshold for swaps with counterparties that are "special entities" is a much lower $25 million notional). Two-and-a-half years after data starts to be reported to swap data repositories, the CFTC staff will prepare a study of the swap markets. Nine months after the study, the CFTC may put in place a lower $3 billion threshold or propose new rules to change the threshold. Additionally, certain activity where swaps are used to hedge or mitigate risk will be excluded for purposes of calculating gross notional swap exposure (although the definition of "hedging" will apparently be different from the definition found in the position limits rules). The SEC's ***de minimis*** thresholds for security-based swap dealers are $3 billion notional in the case of CDS, $150 million for all other security-based swaps, and $25 million notional in the case of security-based swaps with "special entities," which are states, municipalities, state and federal agencies, pension plans, and endowments.

The final rules also include definitions of "major swap participant" and "major security-based swap participant." A person will be a major swap participant if it maintains a "substantial position" in swaps, excluding swaps held to hedge or mitigate commercial risk; if it has outstanding swaps that create "substantial counterparty exposure" that could have serious adverse effects on the financial stability of the U.S. bank system or financial markets; or if it is a "financial entity" that is highly leveraged (i.e., a ratio of total liabilities to equity of 12 to 1) relative to its capital and holds a substantial position in swaps. "Substantial position" is defined by the CFTC based on numerical criteria. A substantial position is defined to be daily average current uncollateralized swap exposure of $1 billion for any swap category (or $3 billion for rate swaps). Substantial position is also defined to be potential future swap exposure of $2 billion for any swap category ($6 billion for rate swaps) determined by multiplying the notional principal amount of a person's swap positions by risk factors set forth in the final CFTC rule. Such amounts are further adjusted by discounts for swaps subject to master netting arrangements and swaps cleared or subject to daily mark-to-market margining. Finally, substantial counterparty exposure is defined as current uncollateralized exposure of $5 billion or the sum of current uncollateralized exposure and potential future exposure of $8 billion across all swap positions. The SEC has adopted its own numerical thresholds for determining substantial position with respect to security-based swaps.

Given the importance of this rule to industry participants, we will publish a full article on this topic in our next issue.

CFTC SUED BY TWO INDUSTRY GROUPS OVER REGISTRATION RULE (April 17, 2012)

The Investment Company Institute ("ICI") and the U.S. Chamber of Commerce (the "Chamber") have filed a legal challenge to the CFTC's final rule requiring that registered investment companies that transact in commodity futures and options must register with the CFTC as "commodity pool operators" ("CPOs"). The complaint alleges that the CFTC reached its decision to require CPO registration without satisfying the agency's obligation to weigh the costs or benefits of the rule. Specifically, ICI and the Chamber charge that the CFTC's Rule 4.5 amendment (which requires advisers to registered investment companies such as mutual funds, which are already regulated by the SEC, to be dually regulated by the CFTC as CPOs) violates the Commodity Exchange Act and the Administrative Procedure Act. The complaint also requests injunctive relief to prevent the CFTC from implementing the Rule 4.5 amendments adopted on February 24 of this year. For many registered investment companies, the amendments would limit their ability to use commodity interests, even as part of a hedging strategy, because they would no longer be exempt from CPO registration. Since dual

regulation likely would raise a number of interpretive and operational issues for registered investment companies, a large number of registered investment companies may simply decide to exit the futures markets to avoid this dilemma. Additionally, as alleged in the complaint, market participants have grown increasingly concerned about the costs of such implementation. This current suit follows on the heels of a complaint filed last December by ISDA and SIFMA that challenged the CFTC's position limit rules on similar cost-benefit grounds.

COME SEE US

Speaking Engagements

Ilene Froom is speaking at the ISDA "2011 ISDA Equity Derivatives Definitions Symposium," April 30, Chicago.

Joel Telpner and **Ilene Froom** are speaking at the New York City Bar Association Program: "Futures & Derivatives 2012: Distinguishing Markets & Understanding Converging Regulatory Regimes," May 3, New York.

Jonathan Ching is speaking at the Futures Industry Association: "34th Annual Law & Compliance Division Conference on the Regulation of Futures, Derivatives and OTC Products," May 9–12, Baltimore.

Jay Tambe, **Joel Telpner**, and **Aviva Warter Sisitsky** are speaking at the New York State Bar Association Derivatives and Structured Products Law Committee May meeting on: "Derivatives Litigation—Developments and Recurring Themes," May 16, New York.

Alice Yurke is speaking at the Euromoney Seminars "North American Structured Products Conference," June 19–20, Boston.

For more information on any of the above speaking events, please contact one of the Editors.

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