WSGR ALERT

OCTOBER 2011

PROPOSED DODD-FRANK RULES IMPACT END-USERS OF FOREIGN EXCHANGE DERIVATIVES

Background

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was enacted. Title VII of Dodd-Frank amends the Commodity Exchange Act (CEA) and other federal securities laws to provide a comprehensive new regulatory framework for the treatment of derivatives, which are generally defined as "swaps" under Section 721. Dodd-Frank provides for the following, among other things:

- The registration and regulation of swaps dealers and major swap participants
- The implementation of clearing and trade execution requirements for swaps
- The establishment of recordkeeping and reporting requirements for swaps

The definition of swaps under the Dodd-Frank Act is quite broad and includes a wide variety of foreign exchange (FX) derivatives, such as FX swaps, FX forwards, currency swaps, currency options, and non-deliverable forward contracts (NDFs).

For corporate end-users of FX derivatives, there are two proposed key exemptions from the clearing and trading requirements of Dodd-Frank. First, the Secretary of the Department of the Treasury has been authorized under the CEA to make a written determination of whether or not FX swaps and FX forwards should be regulated as swaps under the CEA. Section 1 of this alert, titled "Department of Treasury Proposal," summarizes the proposed Treasury release that provides for the exemption of certain specified types of FX swaps and FX forwards from the definition of swaps under the CEA (other than with respect to certain proposed recordkeeping and other limited provisions under the CEA). For corporate end-users of FX derivatives other than physically settled FX swaps and FX forwards, there is a second exemption from the clearing and trading requirements of Dodd-Frank provided by the so-called "End-User Exception."

Section 2 of this alert, titled "The End-User Exception," sets forth the proposed rules that would be applicable to an FX derivative entered into by a corporate end-user to the extent that such FX derivative is not subject to the trading and clearing exemption provided by the Treasury proposal. Finally, the remainder of this alert summarizes a variety of other proposed rules and regulations that will be applicable to corporate end-users of FX derivatives under Dodd-Frank. Please note that almost all of the rules discussed in this alert are in proposed form and therefore may be subject to significant modification or revision prior to final adoption.

1. Department of Treasury Proposal

On April 29, 2011, the Treasury issued a notice of proposed determination pursuant to which the Treasury would exempt both FX swaps and FX forwards (as currently defined under the CEA) from the definitions of swaps under the CEA going forward.

An "FX swap" is narrowly defined by the CEA and the Treasury's proposed determination as a transaction that solely involves:

- an exchange of different currencies on a specified date at a fixed rate that is agreed upon at the inception of the contract covering the exchange, or
- a reverse exchange of those two currencies at a later date and at a fixed rate that is agreed upon at the inception of the contract covering the exchange.

The definition of an "FX forward" is also narrowly defined under the CEA to be "a transaction that solely involves the exchange of two different currencies on a specified future date at a fixed rate agreed upon on the inception of the contract covering the exchange."

The Treasury clearly states in the proposed determination that the Secretary's authority to exempt FX swaps and FX forwards from the definition of swaps under the CEA is limited solely to FX derivative transactions that fit within the above definitions, and that it *does not* extend to any other type of FX derivative transaction. As a result, FX derivative transactions such as FX options, currency options, and NDFs will not be exempt from the definition of swaps under the CEA pursuant to the Treasury's exception, as these instruments do not fit within the statutory definitions of FX swaps and FX forwards set forth above. These FX derivatives will be subject to the clearing and trading requirements of Dodd-Frank discussed below unless another exemption is available.

In support of its decision to exempt FX swaps and FX forwards from the definition of swaps under Dodd-Frank, Treasury sets forth a series

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of justifications in support of its position, including the fact that FX swaps and FX forwards have fixed-payment obligations, are settled physically, and typically have short-term maturities for which the settlement risk is already addressed through a highly developed payment-versus-payment settlement system.

It is important to note that while the proposed determination would exempt FX swaps and FX forwards from Dodd-Frank's clearing and trading requirements, these types of transactions still would be subject to the following Dodd-Frank provisions: (1) the requirement to report swap trade data to swap repositories, (2) the business conduct standards proposed for swap dealers and major swap participants, and (3) anti-evasion provisions.

2. The End-User Exception

If your corporation trades FX derivatives other than physically settled FX swaps and FX forwards that do not qualify for the proposed Treasury exemption, you may be able to rely on the exemption from Dodd-Frank's clearing and trading requirements provided to corporate entities that meet specified requirements set forth by the Commodity Futures Trading Commission (CFTC). This exemption is commonly referred to as the End-User Exception.

The Dodd-Frank Act amended the CEA to, among other things, require that swaps be cleared through a derivatives clearing organization (DCO) if the CFTC determines that the swap is the type that is subject to the CEA clearing requirements (unless an exception to mandatory clearing is available). It also required that any swap determined to be subject to the clearing requirement must be executed on a registered trading platform.

However, the CEA provides for an elective exception to the mandatory clearing requirement for a non-financial entity that uses swaps to hedge or mitigate its financial risk, and that also complies with certain notification requirements to be determined by the CFTC under the CEA.

On December 23, 2010, the CFTC released a proposed rulemaking release titled "End-User Exception to the Mandatory Clearing of Swaps" that sets forth in more detail the proposed rules for the End-User Exception. Under the release, in order to qualify for the clearing exception, a corporate end-user of FX derivatives would need to meet the following conditions:

- Non-Financial Entity. The End-User Exception is available only to counterparties that are not financial entities.[1] Most corporations that use FX derivatives to hedge their FX exposures should meet this requirement.

- Hedging or Mitigating Commercial Risk. The CFTC states in the release that the determination of whether a position is used to hedge or mitigate commercial risk should be done on a case-by-case basis by examining the facts and circumstances at the time the swap is entered into, and that it should take into account the entity's overall hedging and risk strategy. It further states that an entity's overall hedging and risk strategy will be helpful in determining whether or not a particular derivative transaction has been designed to hedge or mitigate risk in a manner designed to comply with the clearing exemption. The release also lists the following swaps that would be deemed to be used to hedge or mitigate commercial risk:

  - Swaps economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from:

    - the potential change in the value of assets that a person owns, produces, manufactures, processes, or merchandises, or reasonably anticipates owning, producing, manufacturing, processing, or merchandising in the ordinary course of business of the enterprise;

    - the potential change in the value of assets that a person has incurred or reasonably anticipates incurring in the ordinary course of business of the enterprise;

    - the potential change in the value of services that a person provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise;

    - the potential change in the value of assets, services, inputs, products, or commodities that a person owns, produces, manufactures, processes, merchandises, leases, or sells, or reasonably anticipates owning, producing, manufacturing, processing, merchandising, leasing, or selling in the ordinary course of business of the enterprise;

    - any potential change in value related to any of the foregoing arising from foreign exchange rate movements associated with such assets, liabilities, services, inputs, products, or commodities; or

    - any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's current or anticipated assets or liabilities.

[1] Subject to limited exceptions, financial entities include swap dealers, major swap participants, commodity pools, and private funds such as hedge funds, pension funds, and entities that are engaged in the banking or financial business.

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- Swaps that qualify as bona fide hedging for purposes of an exemption from position limits under the CEA

- Swaps that qualify for hedging treatment under Financial Accounting Standards Board Accounting Standards Codification Topic 815, Derivatives and Hedging (formerly known as Statement No. 133)

These guidelines apply provided that such swap is:

- not used for a purpose that is in the nature of speculation, investing, or trading; and

- not used to hedge or mitigate the risk of another swap or securities-based swap, unless the other swap itself is used to hedge or mitigate commercial risk in the manner set forth herein or under the equivalent definitional rule governing security-based swaps promulgated by the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934.

- Board of Directors Approval for SEC Registered Corporations. Under the proposed rules, any public company registered under the Exchange Act that would like to utilize the End-User Exception would be required to have an appropriate committee of its board of directors review and approve the decision to enter into swaps that are subject to the clearing exception. Such committee would need to provide review and approval on a transaction-by-transaction basis. The CFTC notes in the release that either a board resolution or amendment to a board committee's charter can authorize a committee to review and approve the decision not to submit the swap for clearing or trading. The CFTC also notes that the authorized committee could adopt policies and procedures that would be used by the committee in connection with such review and approval processes on a periodic basis or subject to other conditions as approved by the board of directors. A number of commentators to the end-user release have requested that the CFTC reconsider the requirement to have the committee approve the exception for each swap on a case-by-case basis and instead allow committee authorization on a periodic basis for a particular type of swap transaction given the scheduling and administrative difficulties in having a committee meet and approve each swap transaction. In addition to this board-approval requirement, any public company seeking to use the End-User Exception will need to provide the corporation's SEC Central Index Key information and notification that the authorized committee of the board of directors has approved the decision not to clear the swap.

- Notification Requirements. In addition to the two notification requirements specified above for public corporations, the proposed rules require non-financial institutions seeking to avail themselves of the End-User Exception to provide on a case-by-case basis information with respect to how the corporation expects to meet its financial obligations under the swaps, along with specified information with respect to any credit support, pledge of assets, guarantees, reliance on available resources, or other means by which it might meet its financial obligations under the swaps. As with the board-approval requirement, numerous commentators to the release have requested that the CFTC reconsider the need to provide this notification each time the corporation enters into a swap, and instead allow a corporation to provide this information on a periodic basis with the understanding that it would be applicable to each swap entered into during that period unless the corporation provides notice to the contrary.

Please note that the decision to use the End-User Exception is at the election of the non-financial user, who can still decide to clear the FX derivative to the extent that there is a clearing entity willing to do so.

3. Margin Requirements for Uncleared Swaps

Both the CFTC and the prudential regulators[2] have issued separate proposed releases setting forth the margin requirements for uncleared swaps for swap dealers and major swap participants. Both sets of proposed rules will require that swap dealers and major swap participants collect margin from their respective counterparties, subject to certain exceptions. The margin requirements applicable to a corporate end-user of FX derivatives will depend on whether its counterparty is a swap dealer or major swap participant that is governed by either the prudential regulators or the CFTC. If the counterparty for a corporate end-user of FX derivatives is a financial institution such as a bank, which is often the case with corporate end-users of FX derivatives (particularly if that corporate end-user has a credit agreement in place with that same financial institution), then the corporate end-user will be subject to the margin requirements specified by the prudential regulators. If a corporate end-user enters into an FX derivative with a swap dealer or major swap participant that is not subject to oversight by the prudential regulators, then the corporate end-user will be subject to the margin requirements for uncleared swaps specified by the CFTC.

While the proposed rules are similar in a number of respects, one key difference is the proposed margin requirements for non-

[2] The prudential regulators consist of the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency.

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financial end-user counterparties. The prudential regulators propose to require that swap dealers and major swap participants collect initial and variation margin from non-financial end-users of swaps to the extent that the exposure of the swap dealer or major swap participant to the end-user exceeds credit limits or threshold amounts, as determined by the swap dealer counterparty. The swap entity will be required to collect the excess initial margin or variation margin over the specified threshold amounts when the cumulative required initial margin or variation margin for transactions with the non-financial end-user exceeds the initial margin or variation margin threshold amount, respectively. If this rule is adopted as proposed, it essentially would eliminate much of the benefit of the End-User Exception from the clearing requirements because corporate end-users of swaps would still be subject to margin requirements if their respective counterparties are financial institutions subject to regulation by the prudential regulators.

The CFTC's proposal would exempt non-financial end-users from the margin requirements. Therefore, any uncleared FX derivatives entered into by a corporate end-user would not be subject to margin requirements if the swap entity counterparty is not subject to the prudential regulators' regulatory regime. However, under the CFTC proposal, all swap dealers and major swap participants would be required to have in place some form of credit support arrangement. The proposal does not specify any requirements as to the terms of such credit support agreements or margin arrangements other than to state that a swap entity may accept as margin from a non-financial entity only those assets for which the value is "reasonably ascertainable on a periodic basis in a manner agreed to by the parties in the credit support arrangements." Corporate end-users of FX derivatives should be able to meet the requirement to have some form of credit support arrangement to the extent that they currently have in place an International Securities Dealers Association (ISDA) Credit Support Annex (CSA), although the form of such a CSA is likely to be modified prior to the required implementation period of the various Dodd-Frank initiatives. If an end-user elects to clear their swaps, that action will be subject to the margin requirements specified for cleared swaps. Please note that these margin requirements do not require the swap dealer or major swap participant to post margin or collateral to a non-financial end-user. The margin collection requirements work in only one direction.

4. Timetable

Predicting the timetable for the implementation of these various Dodd-Frank initiatives is very difficult in light of the large number of proposed rules and the number of regulators involved in the rulemaking process. On September 20, 2011, the CFTC issued a proposed rule that specifies the proposed timeline and schedule with respect to the clearing, exchange trading, documentation, and margin requirements, also known as the Clearing Timetable Rules. In the September 2011 proposal, the CFTC notes that the phase-in periods for the Clearing Timetable Rules would not commence until a large number of conditions precedent were satisfied, along with the adoption of a number of final rules that are prerequisites to the implementation of the rules, particularly the finalization of releases with respect to (1) the definition of key swap terms, (2) the End-User Exception, and (3) rules relating to the protection of cleared swaps' customer contracts and collateral.

In July 2011, the CFTC adopted a final rule that sets forth the procedures and process with respect to the CFTC's review of swaps for mandatory clearing. In the September 2011 proposal, the CFTC stated that it initially will consider mandatory clearing determinations for swaps that currently are being cleared by derivatives clearing organizations, such as interest rate swaps, credit default swaps, and commodity swaps. There was no mention of FX swaps in the release among the types of swaps that would first be evaluated with respect to a mandatory clearing requirement. The CFTC states in the release that it plans in the "near term" to begin the review process for issuing mandatory clearing determinations with respect to these types of swap arrangements. The September 2011 proposal provides that the CFTC would have discretion to phase-in the implementation of any clearing requirements for 90, 180, or 270 days, depending on the types of entities that are party to the swap. Non-financial entities, such as corporate end-users of FX derivatives, will be granted the longest phase-in period of 270 days. The trigger for the implementation of the phase-in period would be the finalization of all the prerequisites specified in the release and the CTFC's notification that this particular type of swap is subject to the clearing mandate.

FX swaps that are subject to the clearing requirement but do not meet either the requirements of the Treasury exception or the End-User Exception will be required to be traded on a designated contract market (DCM) or a swap execution facility (referred to as "SEF," which is a newly created category of trading facilities under Dodd-Frank). If no DCM or SEF makes the swap available for trading, the requirement for the swap to be traded on an exchange will not apply. A swap that is subject to the clearing requirement will be subject to the exchange trading requirement either (1) on the same timetable as the clearing requirements or (2) 30 days after the first date on which the swap is made available for trading on a DCM or SEF.

In addition, the September 2011 proposal sets forth phased-in compliance with respect to swap documentation and margin requirements. Similar to the clearing requirements, compliance with the margin and documentation requirements would provide for a phase-in period of 90, 180, or 270 days after the publication of the respective final rule in the Federal Register, depending on the type of entity involved in the swap. We generally would expect that

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corporate end-users of FX derivatives would fall in the 270-day phase-in period.

Finally, the CFTC has posted on its website an implementation timetable for its various rules, titled "Outline of Final Dodd-Frank Title VII Rules the CFTC May Consider in 2011 and the First Quarter of 2012." Please contact us to discuss the content and timing of any of the various proposed rules set forth in this alert or the timeline.

5. Documentation Requirements

Given the large number of rulemaking initiatives that are still in proposed form, it is difficult at this time to provide much guidance with respect to potential changes to the current form of the ISDA Master Agreement and Schedules that will result from the implementation of the various Dodd-Frank initiatives. We would expect that, even with respect to over-the-counter FX derivatives that are exempt from clearing by either the Treasury exception or the End-User Exception, parties to any existing ISDA Master Agreement and Schedule will need to amend their ISDA documentation to account for the wide range of new requirements under the various proposed swap rules, including, for example, the following:

- Representations by corporate end-users of derivatives with respect to their compliance with the End-User Exception to be eligible for the clearing and trading exceptions
- Representations and covenants that the parties have complied and will comply with the various applicable provisions of Dodd-Frank
- Covenants regarding compliance with respect to the various recordkeeping and reporting requirements under Dodd-Frank, which typically will be the task of the swap dealer or major swap participant when the corporate end-user is a counterparty
- Provisions in the ISDA Master Agreement that would cross-reference and account for any other documentation entered into with futures commission merchants (FCMs) with respect to any cleared and exchange-traded swaps
- Provisions with respect to a variety of requirements that swap dealers and major swap participants will be obligated to comply with under the various Dodd-Frank rules
- Provisions regarding the separation of collateral with respect to uncleared swaps

We would expect that the ISDA eventually will provide a new form or amendment (often referred to as a protocol) to the ISDA Master Agreement and Schedule when the relevant applicable rules have been finalized, which means that it could be quite some time before such a form is available. In addition, corporate end-users that seek to rely on the clearing exceptions will enter into a credit support agreement (such as an ISDA CSA) if their respective counterparties are subject to CFTC regulation or a margin agreement (in the form of an ISDA CSA or some other agreed-upon form of documentation) if the counterparty is subject to the prudential regulators.

Finally, if a corporate end-user elects to have its FX derivatives cleared notwithstanding the Treasury exception or the End-User Exception because it provides better economic terms, greater liquidity, or other reasons, then such corporate end-user will need to select a clearinghouse to clear its trades and establish a relationship with a participant who can provide access to the clearing process. It most likely will be required to enter into documentation provided by the FCM as to who could provide such service. ISDA, in conjunction with the Futures Industry Association, has published a standard form of agreement that is designed to provide for the clearing and trading of over-the-counter derivatives that are required to be cleared under Dodd-Frank. We would expect the documentation for cleared swaps to be subject to more limited negotiation than the bilateral ISDA Master Agreement, Schedule, and related ISDA documentation.

6. Recordkeeping and Reporting Requirements

The recordkeeping and reporting requirements for swaps (including FX derivatives) are quite complex. There is a set of "interim final rules" issued by the CFTC that applies to any FX derivative that was effective on or entered into after July 21, 2010 (the effective date of Dodd-Frank), and prior to the final effective date of recordkeeping and reporting rules described below. These interim rules provide that corporate end-users must keep and maintain the following records:

- Information required to identify and value the FX derivative
- The date and time the FX derivative was entered into
- The price of the FX derivative
- Whether the FX derivative was subject to clearing and, if so, the name of the clearing entity
- Any modifications to the terms of the FX derivative
- Any final confirmation for the FX derivative
- For FX derivatives entered into after July 21, 2010, the notional amount of such FX derivative

This information is required to be maintained for five years after the expiration or amendment of any FX derivative. The rule focuses on the maintenance of existing past records of these transactions versus creating new records to meet these requirements.

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On December 8, 2010, the CFTC issued a proposed rule for Swap Data Recordkeeping and Reporting Requirements. This proposed rule requires that corporate end-users of FX derivative must undertake the following actions with respect to their recordkeeping requirements:

- All records required to be kept by the corporate end-user must be kept for five years after the final termination date of the FX derivative
- Corporate end-users are required to keep full, complete, and systemic records, including all pertinent data and memoranda, with respect to each FX derivative
- All records must be retrievable within three business days during the required retention period
- All records must be available for inspection by the CFTC, the Department of Justice, the SEC, or any prudential regulator

In addition to these recordkeeping requirements, there are a number of reporting requirements that will be applicable to swap transactions. These reporting requirements are applicable to you as a corporate end-user of FX derivatives only in the event that your counterparty is neither (1) a clearinghouse in the case of a cleared swap or (2) a swap dealer or major swap participant in the case of an uncleared swap. As a result, you will be subject to these reporting requirements only if your counterparty is another end-user, which will be extremely unlikely for most corporate end-users of FX derivatives.

If you have any questions about this alert, please contact Michael Occhiolini at (650) 320-4688 or mocchiolini@wsgr.com, Erik Franks at (650) 565-3879 or efranks@wsgr.com, or your regular Wilson Sonsini Goodrich & Rosati contact.

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