SUTHERLAND

LEGAL ALERT

May 12, 2010

Pending Derivatives Legislation Would Create Legal Uncertainty for Existing Contracts—Particular Concerns for End-Users

There never was much doubt that the regulatory reform legislation being considered in the wake of the recent financial meltdown would change the way in which the over-the-counter (OTC) derivatives business is conducted going forward. From the outset, the Obama Administration proposed regulatory changes that would dramatically alter the way current market participants do business, making the registration and regulation of swap dealers -- and "major swap participants"-- as well as central clearing of "standardized" swaps keystones of its reform proposals. In recent days, however, the Congressional effort to reform OTC derivatives has taken a decidedly new turn from ushering in a new regulatory structure toward also rewriting the rules governing existing transactions. If Congress continues down this path, it could cause major, unintended upheaval in the OTC derivatives market, undermining the U.S. economy's nascent recovery and increasing rather than curtailing risks for U.S. businesses. This Legal Alert addresses two areas where retroactive application of the proposed rules for OTC derivatives may have significant adverse consequences for end-users with existing trades.

Requiring Margin for Existing OTC Trades

With respect to central clearing, although there has been considerable debate over which OTC derivatives are sufficiently "standardized" and trade in a liquid market so that they may be eligible for central clearing, it has generally been recognized that there will remain a significant number of OTC derivatives transactions that cannot be centrally cleared and will continue to trade bilaterally. As the reform legislation has made its way through the legislative process, Congress has consistently provided that for these non-cleared trades the regulators would establish minimum initial and variation margin requirements for end-users (and would impose meaningful capital requirements on the swap dealers and major market participants who were on the other side of such trades). Until recently, those following the legislation assumed that the end-user margin rules would apply prospectively to trades entered into after the appropriate regulators adopt new margin requirements.[1] To assume otherwise, would imply that Congress was intending not only to modify the regulatory landscape for the OTC derivatives business conducted after adoption of the reform legislation, but also to rewrite hundreds of thousands of existing contracts whose margin terms differ from those the regulators ultimately adopt. Since the touchstone of the OTC markets has always been "legal certainty" for existing contracts, it seemed inconceivable that Congress would head down this road without carefully considering the implications of adopting legislation that could disrupt the $500 trillion OTC market. Recent events, however, have suggested that even the inconceivable may be possible in the current rush to increase financial regulation.

Margin and the "Buffett Amendment". The derivatives regulatory reform bill drafted by the Senate Agriculture Committee, following the lead of the bill adopted by the House of Representatives as H.R.

---

[1] Indeed, one of the most debated derivatives issues concerning the proposed legislation has been whether to exempt certain end-users from both the new clearing and margin requirements and, if so, what the scope of that exemption should be.

4173 (the House Derivatives Bill), included a provision making it clear that the mandatory clearing requirements of the new legislation would not apply to swaps entered into before the date of enactment. This provision was amended in the Senate Agriculture Committee, reportedly at the urging of representatives of Warren Buffett, to explicitly cover new margin requirements in the same manner as mandatory clearing. The added language would have applied to tens of thousands of transactions and counterparties across the entire spectrum of the OTC market. However, due to the fact that the provision was attributed to Warren Buffett, it was soon labeled a "special interest" provision and became politically toxic. The so-called Buffett amendment was promptly removed from legislation drafted by the Senate Agriculture Committee, and was subsequently excluded when this legislation was melded with the financial regulatory reform bill that came out of the Senate Banking Committee and which is now being debated on the floor of the Senate (the Senate Derivatives Bill).

Unless the retroactive application of the margin requirements is revisited prior to enactment of financial regulatory reform, many end-users are likely to find that their collateral arrangements have effectively been rewritten by this legislation. Interestingly, the proposed legislation provides the regulators with no guidance as to this matter or any explicit authority to provide exemptions for existing trades. In the House Derivatives Bill, which is silent with respect to the use of noncash collateral, margin requirements are intended to "help ensure the safety and soundness of the swap dealer or major swap participant" and are to be "appropriate for the risk associated with the non-cleared swaps" held by such parties.[2] In the Senate Derivatives Bill, the direction to the regulators is even less clear. The Senate Derivatives Bill states that the regulators "may permit the use of noncash collateral, as [they] determine to be consistent with—(A) preserving the financial integrity of markets trading swaps; and (B) preserving the stability of the United States financial system."[3] The Senate language is not clear with respect to whether these factors relate solely to the authorization to permit noncash collateral or whether they also relate to the actual margin requirements themselves.

Under the Senate Derivatives Bill, the only persons that need not be concerned with the decisions of regulators regarding margin are those who qualify as "commercial end-users" and are using swaps to hedge their own commercial risk. The qualifying transactions of these qualifying persons appear to be exempt from both the mandatory clearing and the margin requirements of the bill. Under the House Derivatives Bill, there is no carve-out from the margin requirements applicable to non-cleared trades. Thus, if those requirements are applied retroactively, all existing trades could be affected.

As market participants are well aware, the collateral/margining provisions are key negotiated items in almost every ISDA Master Agreement.[4] According to the most recent margin survey conducted by the ISDA, the estimated number of collateral agreements grew to 171,879 by the end of 2009 and account for

---

[2] House Derivatives Bill at Section 3107.

[3] Senate Derivatives Bill at Section 731.

[4] Not only is there the threshold question of whether or not collateral will be required and, if so, whether it will be one-way or two-way, but there are also innumerable other matters relating to collateral that are negotiated in the Credit Support Annex which becomes part of the ISDA Master Agreement. These negotiated issues include, but are not limited to: (1) the types of collateral that can be transferred; (2) the amount of exposure that need not be collateralized (the "Threshold Amount"); (3) the amount of "excess" collateral required (the initial margin or "Independent Amount"); (4) the timing of collateral transfers; (5) how non-cash collateral will be valued (e.g., haircuts); (6) how disputes regarding the amount of collateral required will be resolved; (7) how collateral will be held and whether it can be rehypothecated; (8) the amount of interest paid with respect to cash collateral; and (9) the right of parties holding collateral to realize upon it after a default by the party posting collateral.

an estimated $3.2 trillion in collateral used to mitigate credit risk in the OTC derivatives market.[5] There also remain a large number of ISDA agreements that do not include collateral provisions. With respect to these agreements, the parties either concluded that collateral was not necessary to address their counterparty credit risk or they negotiated other terms to address that risk (e.g., early termination provisions, exposure caps and resets, set-off, or other risk-reducing provisions). What is so startling in the proposed legislation is that Congress presently seems bent on rewriting the negotiated terms of all or substantially all of these collateral (or no collateral) agreements.

Limited Rights to Terminate in the Event of Unanticipated Margin Requirements. This action by Congress leads to the follow-up question of what recourse parties will have regarding existing swap agreements if they conclude that the regulators' new margin requirements materially change the negotiated terms of their OTC contracts. Can the outstanding trades be terminated or renegotiated? Looking first to the language of the standard ISDA Master Agreement, it would seem that implementation of new regulatory requirements mandating new or increased margin requirements will likely rewrite - _material terms of existing Master Agreements and/or their related Credit Support Annexes. As a result, the parties to such agreements should be able to terminate the transactions due to the occurrence of a Termination Event based on "Illegality." (See § 5(b)(i) of both the 1992 and 2002 ISDA Master Agreements).[6]

However, this is not the end of the story. The Senate Derivatives Bill, under the guise of a provision ironically labeled "Legal Certainty for Long-Term Swaps Entered Into Before the Date of Enactment of the Wall Street Transparency and Accountability Act of 2010," calls into question whether the above "Illegality" provision found in nearly every ISDA Master Agreement ever entered into will itself be legally enforceable. The bill states as follows:

> (B) EFFECT ON SWAPS.—Unless specifically reserved in the applicable bilateral trading agreement, neither the enactment of the Wall Street Transparency and Accountability Act of 2010, nor any requirement under that Act or an amendment made by that Act, shall constitute a termination event, force majeure, illegality, increased costs, regulatory change, or similar event under a bilateral trading agreement (including any related credit support arrangement) that would permit a party to terminate, renegotiate, modify, amend, or supplement 1 or more transactions under the bilateral trading agreement.[7]

Although it is not clear exactly what is meant by "[u]nless specifically reserved in the applicable bilateral trading agreement," the intent of the provision seems to be to preclude contracting parties from exercising their rights to terminate or renegotiate agreements that have been effectively amended or written by the enactment of the new legislation. Through this provision, Congress seems to be saying that it can adopt federal legislation that will not only rewrite the negotiated terms of pre-existing trading agreements, but it

---

[5] ISDA Margin Survey 2010, Preliminary Results April 22, 2010, which is available on the ISDA Web site: www.isda.org

[6] Under these provisions, an Illegality Termination Event occurs when "[d]ue to the adoption of, or any change in, any applicable law after the date on which a Transaction is entered into … it becomes unlawful … to comply with any … material provision of this Agreement relating to such Transaction; …"

[7] Senate Derivatives Bill at Section 739. There is no comparable provision in the House Derivatives Bill.

SUTHERLAND

can also nullify a previously negotiated contractual right to terminate or amend in circumstances where that contractual right would otherwise be applicable.[8]

Mandating Banks to Engage in Swaps Through Affiliates Could Override Seminal Prohibition of Transfers of OTC Contracts Without Counterparty Consent

Another controversial provision added to the Senate Derivatives Bill would require banks to spin out their swaps activities to an affiliate.[9] Interestingly, the debate about this provision has to date focused on how costly this change may be for the banks (an argument that rather than generating concern about the provision seems to garner support for it). Nary a word has been spoken about its potential impact on end-users—the existing bank counterparties.

As market participants are well aware, a great deal of attention is paid by end-users to the selection of the parties with whom they want to enter into OTC trades. Some end-users specifically want to trade with banks because these institutions are subject to regulatory requirements and oversight that, in the eyes of the end-user counterparty, reduce counterparty credit risk. There may well be other reasons for wanting to trade with the bank rather than a bank affiliate. For example, if the end-user is a borrower from the bank and the bank defaults at some point in the future on its OTC obligations, the end-user can probably set-off any amount owed by the insolvent bank against its borrowings from the bank.[10] This set-off right may obviate the need for some end-users to obtain collateral from the bank for its OTC trades. Because the identity of the counterparty is so fundamental to managing counterparty credit risk, the standard ISDA Master Agreement makes it clear that trades cannot be transferred or assigned to another entity without prior written consent.[11]

To the extent that the new derivatives regulatory reform law requires banks to divest themselves of their derivatives business, it will be necessary to either obtain the consent of their existing counterparties or to undertake the transfer without consent in contravention of their contractual obligations. Once again, end-users will be faced with legal uncertainty as to whether their contractual rights to approve transfers or assignments of their OTC trades will be enforced or overridden, and whether to potentially increase the risks they had intended to mitigate by continuing these trades on less favorable credit terms.

---

[8] One way perhaps to address this issue would be for ISDA to publish a new protocol that would permit parties to amend existing agreements by making specific reference to the new law in the manner prescribed in this novel "legal certainty" provision and thereby preserve rights presently enjoyed under the ISDA Master Agreement.

[9] Senate Derivatives Bill at Section 716.

[10] A recent decision in the Lehman bankruptcy proceeding illustrates the pitfalls that can arise when a party seeks to set-off a derivatives claim against an obligation of the bankrupt counterparty's affiliate. See *In re Lehman Brothers Holdings Inc.*, -- B.R. --, 2010 WL 1783395 (Bankr. S.D.N.Y. May 5, 2010). Such affiliate set-offs are likely to be deemed ineffective because they do not satisfy the "mutuality" requirement for set-off imposed by the bankruptcy courts.

[11] See Section 7 of both the 1992 and 2002 ISDA Master Agreements. Sometimes dealers are permitted to assign trades to an affiliate, but only if the trades continue to enjoy the same credit support (e.g., a parent company guaranty) as is provided by the transferring or assigning counterparty.

Conclusion

It is becoming clear that the derivatives regulatory reform legislation being considered by Congress will not only restructure how the OTC market will operate in the future, but may also have material adverse consequences for existing trades. It seems that Congress has given relatively little attention to this matter and has not given the various regulators sufficient guidance and exemptive authority to allow them to carve-out or grandfather existing trades from the impact of the new regulatory regime. The seminal principle underlying the OTC market has always been "legal certainty." Without such certainty, there is concern that parties on the losing side of trades could simply walk away from their contractual obligations with the result that the entire financial system would be exposed to a financial meltdown. It is indeed ironic that Congress may significantly undermine legal certainty for the existing $500 trillion in OTC contracts at the very time it is trying to reduce systemic risk and move the OTC industry toward greater transparency.

At this point, it is incumbent on end-user market participants to closely monitor the pending legislation and perhaps discuss its implications with their dealer counterparties. For some end-users, it may be appropriate to consider amending existing agreements prior to enactment of the legislation in order to preserve rights to early terminate existing trades (or to make other adjustments) where implementation of the legislation is likely to materially interfere with the contractual expectations of the parties.

■ ■ ■

If you have any questions about this Legal Alert, please feel free to contact the attorneys listed below or the Sutherland attorney with whom you regularly work.

James M. Cain	202.383.0180	james.cain@sutherland.com
Paul B. Turner	713.470.6105	paul.turner@sutherland.com
Warren N. Davis	202.383.0133	warren.davis@sutherland.com
William H. Hope II	404.853.8103	william.hope@sutherland.com
Robin J. Powers	212.389.5067	robin.powers@sutherland.com
Mark D. Sherrill	202.383.0360	mark.sherrill@sutherland.com
Doyle Campbell	212.389.5073	doyle.campbell@sutherland.com
Richard E. Grant	202.383.0909	richard.grant@sutherland.com
Meltem F. Kodaman	202.383.0674	meltem.kodaman@sutherland.com