

International **Comparative** Legal Guides



Derivatives **2021**

A practical cross-border insight into derivatives

Second Edition

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1 Documentation and Formalities

1.1 Please provide an overview of the documentation (or framework of documentation) on which derivatives transactions are typically entered into in your jurisdiction. Please note whether there are variances in the documentation for certain types of derivatives transactions or counterparties; for example, differences between over-the-counter (“OTC”) and exchange-traded derivatives (“ETD”) or for particular asset classes.

Documentation standards in the U.S. markets differ between over-the-counter (“OTC”) and exchange-traded derivatives. The ISDA Master Agreement is the most common framework agreement used to document OTC derivatives trading relationships in the U.S. market. Both the 1992 Multicurrency – Cross Border and the 2002 forms of ISDA Master Agreement are widely used by market participants. As an alternative to negotiating the full agreement, parties sometimes rely on long-form trade confirmations for stand-alone trades. Generally, obligations under the ISDA Master Agreement are secured using the 1994 ISDA Credit Support Annex for ISDA Agreements subject to New York law (“**1994 NY CSA**”). If OTC transactions are subject to regulatory margin requirements, parties also customarily use the New York law ISDA 2016 Variation Margin CSA (“**2016 NY VM CSA**”) and, for relationships in scope for mandatory regulatory initial margin, the New York law ISDA 2018 Initial Margin CSA (“**2018 NY IM CSA**,” and together with the 1994 NY CSA and the 2016 NY VM CSA, the “**NY CSAs**”), together with required custody documentation.

Standardized swaps subject to a clearing mandate that are accepted for clearing by clearing organizations generally must be submitted for clearing to the relevant registered Derivatives Clearing Organization (“**DCO**”). Furthermore, if any such swap is made available for trading on a registered execution facility, such swap also must be traded on a registered swap execution facility (“**SEF**”). Market participants gain access to a DCO and SEF through registered brokers that are members of DCOs and SEFs (futures commission merchants or “**FCMs**”). Relationship documentation between a market participant and an FCM typically consists of the FCM’s futures account agreement supplemented by a Cleared Derivatives Addendum published by the Futures Industry Association (“**FIA**”) and the International Swaps and Derivatives Association (“**ISDA**”) to document derivatives-specific clearing issues. To facilitate trading with multiple executing brokers, an FIA-ISDA Cleared Derivatives Execution Agreement often is used to document the process around the giving-up, accepting and rejecting of swap transactions intended to be cleared through the FCM.

1.2 Are there any particular documentary or execution requirements in your jurisdiction? For example, requirements as to notaries, number of signatories, or corporate authorisations.

The legal authority to execute and deliver binding agreements for most types of entities is determined pursuant to the constitutive documents of each party to the transaction. New York law does not impose additional requirements for the due execution of customary derivatives trading documentation.

1.3 Which governing law is most often specified in ISDA documentation in your jurisdiction? Will the courts in your jurisdiction give effect to any choice of foreign law in the parties’ derivatives documentation? If the parties do not specify a choice of law in their derivatives contracts, what are the main principles in your jurisdiction that will determine the governing law of the contract?

The laws of the State of New York are the most commonly specified governing laws for derivatives transactions involving a U.S. counterparty. Section 5-1401 of the New York General Obligations Law expressly upholds parties’ choice to select New York law as the governing law of their contract as long as the contract relates to obligations under a transaction covering at least \$250,000 in the aggregate, subject to limited exceptions.

New York courts generally will give effect to the parties’ choice of law to govern the construction of the applicable derivatives trading documentation. However, whether a particular court ultimately will respect a choice of law clause turns on a number of factors, including whether the trading documentation is validly created under the chosen governing law, whether there is a substantial relationship with such jurisdiction, the application of the chosen law would not violate a fundamental public policy of another jurisdiction that has a materially greater interest in the determination of issues arising out of the trading documentation, the application of the chosen law would not violate the *ordre public* of New York and any consent to the choice of law was not improperly obtained. Notwithstanding, New York law will govern as to procedural matters.

Where the parties’ choice of law is invalid, or the governing law has not been specified, New York courts apply the law of the jurisdiction with the most substantial nexus to the parties and the transaction based on factors such as the place of contracting, negotiation or performance of the contract and/or the place of business or incorporation of the contracting parties.

2 Credit Support

2.1 What forms of credit support are typically provided for derivatives transactions in your jurisdiction? How is this typically documented? For example, under an ISDA Credit Support Annex or Credit Support Deed.

Collateralization of OTC derivatives is routinely required in the U.S. derivatives markets either by virtue of a swap dealer's internal credit risk mitigation requirements or regulatory mandate. The NY CSAs are commonly utilized to document the basic contractual framework for credit support arrangements and specify the types of eligible collateral that can be posted in support of trading exposures. Where a specific trading entity lacks sufficient creditworthiness on its own, for instance in the context of special-purpose vehicles or corporate subsidiaries, third-party or parent guarantees are commonplace. Where OTC derivatives transactions are entered into for the purpose of mitigating commercial risk by corporate end-users and an exemption from mandatory uncleared margin requirements is available, the broad array of collateral assets supporting the corporate indebtedness is often shared by the lenders with the swap providers to secure exposures under the related hedging transactions.

DCOs require initial margin and variation margin for cleared swaps from their clearing members on a daily basis. Clearing member FCMs in turn collect initial margin from their cleared swaps customers in amounts at least equal to the DCO requirement, and exchange variation margin with their customers. DCO rules determine the types of collateral that may be posted in support of customer obligations under cleared swaps and generally provide for a diverse portfolio of acceptable collateral assets including U.S. dollars, select foreign currencies, U.S. government and agency debt and select foreign sovereign debt. DCOs and FCMs are obligated to treat cleared swaps customer collateral as legally segregated and are prohibited from treating the collateral as belonging to any other person, including the DCO, the FCM or any other customer. DCOs are permitted, however, to operationally commingle customer assets.

2.2 Where transactions are collateralised, would this typically be by way of title transfer, by way of security, or a mixture of both methods?

As stated above, OTC derivatives transactions in the U.S. market generally rely on the NY CSAs to document the parties' collateralization arrangements. Under the framework of the NY CSAs, the pledgor transfers collateral to the secured party by way of security only. The NY CSAs include a grant of a security interest in posted eligible collateral and set forth the parties' rights, remedies and duties with respect to collateral. It is worth noting that unless the parties otherwise agree, the secured party will have the right, subject to certain conditions, to use, commingle, rehypothecate and dispose of collateral that has been pledged to it. In light of such broad reuse rights, due consideration should be given by a pledgor to how its claim for a return of any excess of the value of collateral disposed of by the secured party over the amount owed by the pledgor under its relevant transactions would be treated. As a practical matter, the rights of a pledgor to a return of specific posted collateral that has been rehypothecated or otherwise disposed of by a secured party in accordance with a permission to reuse such collateral in most instances will be superseded by the rights of any subsequent transferee of the collateral. In such case, the

pledgor would be left with a general claim against the secured party. Pledgors have the right to request that the secured party segregate independent amounts with a third-party custodian. Certain regulatory mandatory initial margin must be segregated at a third-party custodian.

2.3 What types of assets are acceptable in your jurisdiction as credit support for obligations under derivatives documentation?

The most commonly used types of collateral in connection with OTC derivatives in the U.S. markets are cash in U.S. dollars and U.S. government and agency debt securities. To the extent applicable, regulatory margin rules for uncleared swaps also permit other forms of collateral, including cash in other major currencies, debt securities backed by the European Central Bank or certain foreign creditworthy sovereign entities, liquid and readily marketable equity securities included in major stock indices, debt of the International Monetary Fund and gold. Valuation haircuts and capital charges for assets other than cash and certain government securities apply.

As noted above, clearing houses generally accept a range of collateral types, including similar high-quality, liquid assets such as cash in major currencies and sovereign debt.

2.4 Are there specific margining requirements in your jurisdiction to collateralise all or certain classes of derivatives transactions? For example, are there requirements as to the posting of initial margin or variation margin between counterparties?

Cleared swaps are subject to daily margin requirements set by the DCOs (as supplemented by any additional margin in excess of applicable DCO requirements if required by an intermediating clearing FCM).

Uncleared swaps between swap dealers, major swap participants and their financial end-user swap counterparties are subject to specified minimum initial and variation margin requirements. Swap dealers and major swap participants are obligated to post and collect variation margin to and from each other and financial end-user swap counterparties in amounts sufficient to collateralize daily mark-to-market exposures under such swaps. Initial margin must be exchanged between swap dealers and major swap participants and their financial end-user swap counterparties with material swaps exposure. The threshold for material swaps exposure is being phased-in through September 1, 2022 when entities with an average aggregate notional amount ("AANA") of swaps exceeding \$8 billion, determined based on the daily average of notional amount of swaps during June, July and August of the same year, will be in scope. As of September 1, 2021, entities with an AANA exceeding \$50 billion will be brought into scope. Uncleared swaps minimum margin requirements do not apply to deliverable foreign exchange ("FX") forward agreements and deliverable FX swaps, and do not apply to security-based swaps traded by swap dealers and major swap participants under the Commodity Futures Trading Commission's (the "CFTC") jurisdiction.

Parties must continue to post and collect requisite variation margin amounts on each business day during the life of the swap but are not required to transfer margin unless and until the combined amount of both variation and initial margin due is greater than \$500,000. Initial margin transfers benefit from a \$50 million threshold on a counterparty-by-counterparty basis. While no initial margin documentation is required until the amount of exchangeable initial margin exceeds this threshold,

the level of required initial margin must be carefully monitored to ensure compliance when the \$50 million threshold is reached. Initial margin, where required, must be exchanged on a gross basis, and held segregated from proprietary assets with a third-party custodian.

Minimum initial and variation margin requirements similarly apply to uncleared swaps and security-based swaps traded by swap dealers and security-based swap dealers (“*SBSDs*”) or major swap participants and major security-based swap participants (together with *SBSDs*, “*SBS Entities*”) subject to the jurisdiction of the prudential banking regulators (including the Federal Reserve, the Federal Deposit Insurance Corporation (the “*FDIC*”) and the Office of the Comptroller of the Currency) with financial counterparties. These margin requirements also are set to come into effect in November 2021 for non-bank *SBSDs*. While the prudential banking regulator margin rules are substantially similar to the CFTC rules, the margin rules applicable to non-bank *SBSDs* feature some key differences. Under rules finalized by the Securities and Exchange Commission (the “*SEC*”), non-bank *SBSDs* will be required to post and collect variation margin to and from their financial counterparties in amounts sufficient to cover daily mark-to-market exposure. Non-bank *SBSDs* also will be obligated to collect initial margin (but not to post) from all financial end-users, including those without material swaps exposure. After initial margin exposure exceeds a \$50 million initial margin threshold (calculated based on the aggregate exposure of all swaps and security-based swaps), counterparties with security-based swaps exposure must implement margin documentation and establish processes for posting initial margin within a two-month compliance window. Major security-based swap participants are not required to collect or post initial margin, and collection of initial margin for security-based swaps is not required from financial market intermediaries including other *SBSDs*, swap dealers and stand-alone broker-dealers. The SEC final rules do not affirmatively require segregation of initial margin at a third-party custodian. Other requirements relating to minimum transfer amounts, initial margin calculation methodology, eligible collateral and standardized haircuts for collateral valuation are substantially aligned with the rules adopted by the CFTC and prudential banking regulators.

Certain dually registered *SBSDs* engaged predominantly in a swaps business may elect to comply with the CFTC margin framework for their whole portfolio of swaps and security-based swaps.

2.5 Does your jurisdiction recognise the role of an agent or trustee to enter into relevant agreements or appropriate collateral/enforce security (as applicable)? Does your jurisdiction recognise trusts?

It is common for investment managers to enter into OTC derivatives documentation as an “agent” of an investment fund as principal, or for a trustee on behalf of a trust. Statutory trusts may be established for any lawful purpose under New York law.

2.6 What are the required formalities to create and/or perfect a valid security over an asset? Are there any regulatory or similar consents required with respect to the enforcement of security?

Parties seeking to establish a valid security interest over collateral pledged in connection with U.S. OTC derivatives transactions must carefully analyze which laws govern their situation as the legal requirements for the creation and perfection of

security interests differ in important ways from jurisdiction to jurisdiction. The operative provisions of the NY CSAs, as the most commonly used security arrangements in connection with New York law-governed ISDA Master Agreements, are drafted with a view to the relevant principles and requirements under New York law. However, parties must be mindful of the extent to which other laws such as bankruptcy laws and local laws governing perfection, the effect of perfection and priority of security interests may be relevant to their security arrangements. In addition, international treaties that bind the United States, such as the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, can sometimes pre-empt the parties’ choice of law. If it can be concluded that substantive New York law applies to the relevant collateral, perfection and related matters, the New York Uniform Commercial Code (the “*NYUCC*”) will govern most aspects of the creation, perfection and enforcement of security interests in the common types of collateral (cash and securities) used in U.S. OTC derivatives transactions.

Generally speaking, a security interest in collateral, in which a pledgor has rights, will be created under New York law when value is provided and the parties have entered into a security agreement describing the collateral. The means by which a security interest can be perfected to make it effective against other future creditors of the pledgor depends on various factors, including the type of collateral and the manner in which it is held. By way of example, a security interest in cash collateral posted under a NY CSA and held in New York may be perfected only by the secured party taking possession of the money, either by itself or through an agent who authenticates a record acknowledging that it holds the money for the benefit of the secured party (see *NYUCC* Sections 9–312 and 9–313). A security interest in collateral in the form of securities may be perfected through control of the security entitlement (if the securities are indirectly held through a securities account maintained by a securities intermediary such as a custodian or broker) or the directly held certificated or uncertificated security, or by filing an appropriate UCC financing statement (see *NYUCC* Sections 9–312 and 9–314).

The NY CSAs provide for a secured party’s rights to foreclose and exercise remedies against pledged collateral, as well as notice and cure periods. A secured party generally may choose between judicial foreclosure of the collateral or the exercise of “self-help” remedies under the *NYUCC*. In exercising self-help remedies, a secured party may sell the collateral at a public or private sale or apply the collateral toward the satisfaction of the debt but must act in a commercially reasonable manner with respect to every aspect of a disposition of collateral.

3 Regulatory Issues

3.1 Please provide an overview of the key derivatives regulation(s) applicable in your jurisdiction and the regulatory authorities with principal oversight.

Recognizing the central role OTC derivatives played during the 2008/2009 financial crisis, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “*Dodd-Frank Act*”) established a comprehensive regulatory framework directly regulating market participants and derivatives products to mitigate counterparty credit risk, increase transparency in derivatives trading and promote market integrity through enhanced business conduct standards.

The Dodd-Frank Act amends, among others, the Commodity Exchange Act (the “*CEA*”), the Securities Act of 1933 and the Securities Exchange Act of 1934 and confers broad authority to

issue regulations in respect of, and to provide principal regulatory oversight over, swaps, swap dealers, major swap participants, eligible contract participants (“*ECPs*”), swap data repositories, DCOs and SEFs to the CFTC with regard to swaps, and to the SEC (the SEC, together with the CFTC, the “*Commissions*”) with regard to security-based swaps. The Dodd-Frank Act and regulations thereunder governing swaps activity apply to activities that take place within the United States and to those activities taking place outside the United States that “have a direct and significant connection with activities in, or effect on, commerce of the United States” or are designed to contravene any rules or regulations promulgated by the Commissions to prevent evasion of the Dodd-Frank Act. In guidance regarding the extraterritorial application of the Dodd-Frank Act, the CFTC has taken the view that swaps activities of any United States person (“*U.S. Person*”) have a direct and significant effect on commerce in the United States, whether or not such activities occur within the United States, and therefore will be subject to the Dodd-Frank Act. Conversely, in such guidance, the CFTC proposed that the Dodd-Frank Act and regulations thereunder apply to non-U.S. Persons only where such non-U.S. Person is required to register as a swap dealer or a major swap participant or where the other party to the swap is a U.S. Person. In its guidance for the cross-border framework for the regulation of security-based swaps, the SEC adopted a territorial approach that focuses on activities occurring within the United States even if the risks materialize offshore. Under such approach, any security-based swap transaction arranged or negotiated by U.S. personnel counts toward a person’s SBSB registration requirement.

The CFTC has substantially completed the creation of the regulatory framework for swaps. Under rules regarding record-keeping requirements for swap transaction data, market participants are required to keep “full, complete and systematic records” of their activities related to swaps. The details of the information to be maintained include all data regarding the creation of a swap, swap confirmation, any modifications to the terms of the swap and, where applicable, all records demonstrating that the parties to a swap are entitled to make use of the end-user exception from the clearing requirement. These records must be maintained for the duration of the swap and for a period of five years following the swap’s termination.

Rules regarding real-time reporting and public dissemination of transaction data for swaps apply to all market participants and are intended to facilitate regulatory oversight, promote transparency and enhance price discovery in the swaps markets by making swap transaction and pricing data available to regulators and the public in real-time while protecting the anonymity of market participants. Swap transactions must be reported to a registered swap data repository and disseminated by the swap data repository to the public as soon as technologically practicable following execution and upon any material amendment. Any swap that is not executed on a designated contract market or SEF must be reported to a swap data repository by a “reporting party.” The reporting party for each swap is determined based on the regulatory status of the parties to the swap. Where one party to a swap is a swap dealer or major swap participant, the swap dealer or major swap participant will be the reporting party for that swap. If neither party to a swap is a swap dealer or major swap participant and only one party to the swap is a U.S. Person, the U.S. Person will be the reporting party for that swap, unless otherwise agreed.

The Dodd-Frank Act mandates central clearing for all swaps that are required to be cleared, unless an exception applies. Currently, only certain standardized interest rate swaps and credit index swaps have been determined by the CFTC to be subject to the clearing mandate. The SEC has not made any clearing determination for security-based swaps.

Clearing houses impose margin requirements for all swaps that are centrally cleared. The CFTC and prudential banking regulators also have adopted regulations requiring that all swap dealers and major swap participants collect appropriate minimum margin for non-cleared swaps from their financial swap counterparties pursuant to prescribed margin calculation methodologies. Swap dealers and major swap participants are not required to collect margin from non-financial end-users unless uncollateralized exposure exceeds certain thresholds set by the swap dealer or major swap participant based on approved internal risk models.

While the SEC by now has substantially completed its security-based swap regulatory regime as well, most of the security-based swap rules have not yet come into effect. Following the adoption and effective date of the final rule regarding the cross-border application of security-based swap requirements, entities that meet the requirements of the definition of “security-based swap dealer” or “major security-based swap participant” will be required to register with the SEC by November 1 and December 1 of 2021, respectively. Registration will trigger the effectiveness of the full suite of security-based swap rules regarding segregation, capital and margin, recordkeeping and reporting, business conduct standards, trade acknowledgment and verification, and risk mitigation requirements at such time.

Registered SBS Entities are required to implement risk mitigation techniques such as maintaining proper trading relationship documentation, and regular portfolio reconciliation and compression. SBSBs that do not have a prudential banking regulator are subject to minimum net capital requirements with respect to their security-based swaps positions. The final rules also impose margin requirements for the non-cleared security-based swaps book of non-bank SBSBs. With respect to any such margin collected on security-based swaps, and subject only to limited exceptions, SBSBs are bound by segregation requirements that are modelled after the existing broker-dealer customer asset protection rule, unless waived by the counterparty. SBSBs who are dually registered with the SEC and the CFTC and who are predominantly engaged in swaps business may elect to comply with the capital, margin, and segregation framework under the CFTC’s framework for both swaps and security-based swaps if certain conditions are met. The SEC has not made any clearing determinations for security-based swaps thus far, and has not yet finalized its rulemaking for the end-user clearing exception.

The final rules adopted by the SEC provide a welcome degree of alignment with the existing CFTC regulatory regime applicable to swaps, and the Commissions have stated their intent to continue to explore further harmonization across their rule sets. However, significant discrepancies between the swaps and security-based swaps regulatory frameworks and between bank and non-bank SBSBs remain, which may result in additional compliance burdens for market participants and competitive disparities.

3.2 Are there any regulatory changes anticipated, or incoming, in your jurisdiction that are likely to have an impact on entry into derivatives transactions and/or counterparties to derivatives transactions? If so, what are these key changes and their timeline for implementation?

Due to the disruptive effect on financial markets of the global spread of the coronavirus disease, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions announced last year a further delay of the implementation of the final phases of the non-cleared derivatives margin requirements. Pursuant to this extension, the

final implementation of independent margin requirements for entity groups with an AANA of non-cleared derivatives greater than \$8 billion now will take effect on September 1, 2022. In the interim, entity groups with an AANA of non-cleared derivatives positions in excess of \$50 billion will become subject to the independent margin requirements from September 1, 2021.

As mentioned above in question 3.1, compliance dates for SBSB and major swap participant registration will occur during the second half of calendar year 2021, triggering the effectiveness of security-based swap rules.

3.3 Are there any further practical or regulatory requirements for counterparties wishing to enter into derivatives transactions in your jurisdiction? For example, obtaining and/or maintaining certain licences, consents or authorisations (governmental, regulatory, shareholder or otherwise) or the delegating of certain regulatory responsibilities to an entity with broader regulatory permissions.

The Dodd-Frank Act limits transactions in non-cleared derivatives to persons that qualify as ECPs. Entities who have total assets in excess of \$10 million, or have a net worth in excess of \$1 million and use derivatives for hedging purposes, satisfy the ECP requirement. Other qualifications are available as well.

Swap dealers and major swap participants will be required to register with the CFTC, the SEC or both, and will be subject to heightened reporting requirements, business conduct standards and other regulations governing their swaps activities. In a joint rulemaking, the Commissions clarified that a person will be deemed to be a swap dealer or SBSB if that person engages in swap or security-based swap dealing activity with U.S. Persons above certain *de minimis* thresholds. Major swap participants and major security-based swap participants are deemed to be those entities that maintain substantial positions in any major swap category excluding positions held for hedging or mitigating commercial risk, or whose swaps or security-based swaps activities create substantial counterparty exposure or could have serious adverse effects on the financial stability of the U.S. banking system or financial markets.

Operators and trading advisors of commodity pools, generally entities that pool the investments of several investors, who enter into swaps above a *de minimis* threshold must register with the CFTC or qualify for an exemption.

To facilitate industry-wide compliance with the external business conduct rules and other Dodd-Frank regulatory requirements and to obviate the need for bilateral negotiations, ISDA launched the ISDA August 2012 Dodd-Frank Protocol and the ISDA March 2013 Dodd-Frank Protocol (the “*ISDA DF Protocols*”). The ISDA DF Protocols allow adhering market participants to deliver required information to their counterparties and to amend their existing ISDA documentation to comply with certain requirements under the Dodd-Frank Act. In order to be able to trade with swap dealers and major swap participants, each market participant is expected to adhere to the ISDA DF Protocols or enter into equivalent bilateral agreements. Market participants wishing to enter into derivatives transactions also must procure an entity-specific legal entity identifier prior to commencing trading.

3.4 Does your jurisdiction provide any exemptions from regulatory requirements and/or for special treatment for certain types of counterparties (such as pension funds or public bodies)?

The Dodd-Frank Act and, with respect to swaps, related rulemaking by the CFTC provide a number of entity and

transaction-based exemptions from certain regulatory requirements relating to mandatory clearing, exchange trading and minimum margin for non-cleared swaps.

An exception from mandatory clearing and exchange trading is available for non-financial entities that enter into swaps for hedging purposes. Swaps generally are held for the purpose of “hedging or mitigating commercial risk” if any such position is economically appropriate to reduce risks in the conduct and management of a commercial enterprise where such risks arise from the potential change in the value of (i) assets actually, or anticipated to be, owned, produced, manufactured, processed or merchandised, (ii) liabilities that a person has incurred in the ordinary course of business of the enterprise, or (iii) services that a person provides, purchases, or reasonably anticipates providing or purchasing in the ordinary course of business of the enterprise. The exemptions from mandatory clearing and exchange trading are available for publicly listed or reporting companies only to the extent that prior approval by the board or appropriate committee of such company has been obtained. Entities that qualify for the commercial end-user exception from clearing and exchange trading also are exempt from the mandatory minimum margin rules for uncleared swaps, alongside other non-financial end-users, sovereign entities, multilateral development banks and the Bank for International Settlements.

Spot purchases and sales of commodities are not considered “swaps” for purposes of the Dodd-Frank Act requirements. In addition, “swap,” as defined in the CEA, excludes “any contract of sale of a commodity for future delivery,” which generally refers to listed futures contracts, as well as sales of non-financial commodities “for deferred shipment or delivery, so long as the transaction is intended to be physically settled.” Conversely, cash-settled forward contracts are not excluded from the definition of “swap” and will need to be considered in analyzing the applicability of CFTC regulations. Deliverable FX swaps and FX forwards are exempt from many of the requirements of the Dodd-Frank Act. These FX swaps and FX forwards remain subject to the real-time reporting requirements, anti-fraud and anti-manipulation provisions and the enhanced anti-evasion authority of the CFTC under the Dodd-Frank Act but are not impacted by other transaction-level requirements such as clearing, trade execution and recordkeeping. Non-deliverable FX swaps and FX forwards are not exempt from the definition of “swap” and are subject to regulation by the CFTC.

The SEC has yet to finalize its end-user exception from clearing for security-based swaps and, relatedly, no security-based swaps are currently mandated to be cleared. In alignment with the CFTC regulations, the final SEC uncleared margin rules for security-based swaps do not require variation and initial margin to be collected from commercial end-users, multilateral development banks and the Bank for International Settlements. However, the SEC rules do not exempt sovereign entities from variation margin, and initial margin must be collected unless the sovereign entity presents only minimal credit risk.

4 Insolvency / Bankruptcy

4.1 In what circumstances of distress would a default and/or termination right (each as applicable) arise in your jurisdiction?

In addition to the standard ISDA Master Agreement events of default (including the Bankruptcy Event of Default under Section 5(a)(vii)) and termination rights, parties often include in their trading documentation additional termination rights relating to net asset value declines or rating downgrades, depending on the type of counterparty.

Generally, the U.S. Bankruptcy Code renders unenforceable contractual provisions that would otherwise entitle a counterparty to terminate or modify an executory contract based on a debtor's insolvency, financial condition, or the filing of a bankruptcy case (so-called "*ipso facto* clauses"). The purpose of this general rule is to preserve a debtor's assets, including its contractual rights, and therefore promote the debtor's reorganization. Nonetheless, the Bankruptcy Code contains broad exceptions to this general rule for qualified derivatives transactions. In particular, the Bankruptcy Code provides that, notwithstanding the general prohibition of *ipso facto* clauses in bankruptcy, counterparties to qualified derivatives transactions may exercise contractual rights of termination, liquidation, and acceleration even when such rights are conditioned solely on the insolvency, financial condition, or bankruptcy filing of the debtor.

4.2 Are there any automatic stay of creditor action or regulatory intervention regimes in your jurisdiction that may protect the insolvent/bankrupt counterparty or impact the recovery of the close-out amount from an insolvent/bankrupt counterparty? If so, what is the length of such stay of action?

While the Bankruptcy Code imposes an automatic stay on certain creditor actions upon the filing of a bankruptcy petition, there are broad exceptions (so-called "safe harbors") applicable to the close-out of qualified derivatives transactions.

Generally, Section 362 of the Bankruptcy Code provides for a broad stay of creditor enforcement actions, including actions to collect on prepetition claims, set off debts, foreclose on collateral and other security arrangements, or interfere with a debtor's property interests, including contractual rights. Absent prior relief from the bankruptcy court, such automatic stay continues until the bankruptcy case is closed.

The safe harbor provisions of the Bankruptcy Code, however, provide a broad exception to the automatic stay for many financial contracts, including securities contracts, swap agreements, repurchase agreements, commodity contracts, forward contracts, and master netting agreements. In particular, the automatic stay does not stay a counterparty's exercise of any contractual right under any security agreement or other credit enhancement related to one of these safe-harbored agreements to offset or net out any termination or payment amount (see 11 U.S.C. § 362(b)(17)). Additionally, Section 560 of the Bankruptcy Code protects a qualified counterparty's contractual right to liquidate, terminate, or accelerate a swap agreement, notwithstanding the automatic stay and other provisions of the Bankruptcy Code.

The Bankruptcy Code defines "swap agreement" broadly to include a variety of derivatives transactions, including swap, forward, future, option, and spot agreements related to interest rates, currencies, equity and debt indices, credit and credit spreads, commodities, weather, emissions, and inflation, as well as other transactions that are "similar" to those expressly listed. Swap agreements are also defined to include any related security agreement or arrangement or other credit enhancement, including guarantee and reimbursement obligations.

Accordingly, a counterparty to an agreement meeting these qualifications will not be stayed from exercising contractual rights to terminate or liquidate the swap agreement, or to offset or net out close-out amounts. While a bankruptcy filing does not automatically stay a counterparty from exercising such rights, at least one court has found that a counterparty may be deemed to have waived its safe-harbored rights by failing to exercise them promptly after the bankruptcy filing and instead choosing to wait for the market to turn in its favor.

Finally, although the Bankruptcy Code's safe harbors generally protect a counterparty's right to liquidate and terminate derivatives transactions, such provisions do not guarantee a prompt or full recovery of the close-out amount. To the extent the close-out amount exceeds the collateral posted under the agreement, resulting in an unsecured obligation of the debtor, the counterparty's ability to recover such unsecured amount will be subject to the automatic stay and satisfied together with other unsecured creditors pursuant to the plan of reorganization.

4.3 In what circumstances (if any) could an insolvency/bankruptcy official render derivatives transactions void or voidable in your jurisdiction?

The Bankruptcy Code's safe harbors for qualified derivatives transactions generally prohibit a debtor or bankruptcy trustee from avoiding prepetition transfers made by, to, or for the benefit of "swap participants" or "financial participants" under or in connection with swap agreements. Accordingly, prepetition transfers under qualified agreements, including the payment of any close-out or termination amount or the delivery of credit support, are not generally subject to avoidance. A "swap participant" is defined as an entity that is a party to a swap agreement with the debtor. A "financial participant" includes an entity that is a party to one or more qualified financial contracts having an aggregate outstanding notional balance of \$1 billion or more, or a gross mark-to-market position of \$100 million or more.

The Bankruptcy Code does, however, permit a debtor or trustee to avoid transfers under safe-harbored derivatives transactions if such transfers could be avoided as actual fraudulent transfers. To constitute an actual fraudulent transfer under the Bankruptcy Code, the debtor must have made the challenged transfer to the counterparty with the actual intent to hinder, delay, or defraud other creditors. In addition, where the debtor is itself engaged in fraud, such as, for example, a Ponzi scheme, some courts have declined to apply the Bankruptcy Code's safe harbors to other types of fraudulent transfer claims where the counterparty is shown to have had actual knowledge of the debtor's fraud. Absent these limited exceptions, a prepetition transfer under a qualified derivatives contract is not subject to clawback.

4.4 Are there clawback provisions specified in the legislation of your jurisdiction that could apply to derivatives transactions? If so, in what circumstances could such clawback provisions apply?

As discussed in response to question 4.3, the Bankruptcy Code's safe harbor provisions do not permit the clawback of transfers under qualified derivatives transactions, except in circumstances involving actual fraud.

4.5 In your jurisdiction, could an insolvency/bankruptcy-related close-out of derivatives transactions be deemed to take effect prior to an insolvency/bankruptcy taking effect?

The Bankruptcy Code does not deem bankruptcy-related close-outs of qualified derivatives transactions to have occurred prior to the bankruptcy filing date. Instead, Section 562 of the Bankruptcy Code provides that damages arising from the termination, liquidation or acceleration of a swap agreement shall be measured as of the date or dates of such termination, liquidation, or acceleration. Similarly, should the debtor elect to reject

the swap agreement, damages will be measured as of the date of such rejection, rather than as of the date of the bankruptcy filing. Further, the Bankruptcy Code provides that, if there are no commercially reasonable determinants of value as of the relevant termination date, then damages shall be measured as of the next subsequent date or dates on which commercially reasonable determinants of value are ascertainable. As a result, if the transaction is terminated during extreme market volatility, or at a time when market quotations are not readily available, the close-out amount may be calculated at a later date when better pricing information is available.

4.6 Would a court in your jurisdiction give effect to contractual provisions in a contract (even if such contract is governed by the laws of another country) that have the effect of distributing payments to parties in the order specified in the contract?

Assuming that the contractual provision was enforceable under applicable non-bankruptcy law, a U.S. bankruptcy court would give effect to distribution provisions set forth in a qualified derivatives contract. Section 560 of the Bankruptcy Code provides that no other provision of the Bankruptcy Code shall limit a swap participant's exercise of a contractual right to liquidate a swap agreement. While the Bankruptcy Code does not define what constitutes a "liquidation," courts have held that payments pursuant to priority provisions specified in a swap agreement constitute the liquidation of the swap agreement and are therefore protected. Where, however, the distribution priorities are set forth in a separate contract that does not qualify as a swap agreement under the Bankruptcy Code, such provisions will not be given effect. Finally, because the safe harbor protects contractual rights, the court would first consider whether the contractual provision is enforceable under the applicable non-bankruptcy law governing such contract. If the provision was not enforceable under the applicable non-bankruptcy law, then the bankruptcy court would not be required to enforce it.

5 Close-out Netting

5.1 Has an industry-standard legal opinion been produced in your jurisdiction in respect of the enforceability of close-out netting and/or set-off provisions in derivatives documentation? What are the key legal considerations for parties wishing to net their exposures when closing out derivatives transactions in your jurisdiction?

Yes. ISDA has obtained a standard industry legal opinion confirming the enforceability of the termination, close-out and multibranch netting provisions under New York law-governed ISDA Master Agreements, including in various insolvency proceedings. The opinion is subject to certain assumptions and qualifications, such as the laws of the State of New York governing the ISDA Master Agreement, at least one of the parties being a U.S. party, and salient netting provisions of the ISDA Master Agreement not having been altered in any material respect. Certain types of entities such as insurance companies, credit unions and government entities are excluded from the scope of the opinion. However, where a party to the ISDA Master Agreement is a global systemically important banking institution ("*GSIB*"), the counterparty's right to terminate based on the appointment of the FDIC as receiver or conservator may be suspended for one day or, in the case of a conservatorship,

indefinitely. In addition, limitations to termination rights based on the insolvency or financial condition of certain affiliates of the GSIB may apply under the FDIC's orderly liquidation authority.

5.2 Are there any restrictions in your jurisdiction on close-out netting in respect of all derivatives transactions under a single master agreement, including in the event of an early termination of transactions?

Close-out netting in respect of all transactions under a New York law-governed ISDA Master Agreement is permitted for derivatives transactions that qualify as "swap agreements," encompassing a wide variety of the most common OTC derivatives transactions.

5.3 Is Automatic Early Termination ("AET") typically applied/disapplied in your jurisdiction and/or in respect of entities established in your jurisdiction?

AET does not provide practical benefits with respect to the enforceability of termination or close-out netting rights in the various U.S. bankruptcy, insolvency or similar proceedings and is typically disapplied.

5.4 Is it possible for the termination currency to be denominated in a currency other than your domestic currency? Can judgment debts be applied in a currency other than your domestic currency?

Parties are free to select a termination currency other than U.S. dollars for their New York law-governed ISDA Master Agreements. If a cause of action is based upon obligations denominated in a currency other than U.S. dollars, New York courts will render a judgment in the foreign currency of the underlying obligation. However, such judgment in each case will be converted into U.S. dollars at the rate of exchange prevailing on the date of entry of the judgment.

6 Taxation

6.1 Are derivatives transactions taxed as income or capital in your jurisdiction? Does your answer depend on the asset class?

Income generated from transactions that are treated as derivatives for U.S. federal income tax purposes generally constitutes ordinary income for U.S. federal income tax purposes. However, in certain scenarios, including the taxation of gains or losses resulting from the termination of derivatives contracts, capital treatment could apply. Additionally, there are circumstances where parties can elect at the outset of a transaction to treat gains as capital or to integrate the derivatives transaction with a related capital transaction.

However, U.S. federal income tax is substance-driven, and certain transactions documented as derivatives may be treated as something other than a derivatives contract for U.S. federal income tax purposes. Transactions treated as something other than a derivatives contract generally will be taxed in accordance with the substance of the alternative characterization, and not as a derivative.

This answer does not depend on the asset class.

6.2 Would part of any payment in respect of derivatives transactions be subject to withholding taxes in your jurisdiction? Does your answer depend on the asset class? If so, what are the typical methods for reducing or limiting exposure to withholding taxes?

Generally, no withholding obligation applies to transactions that are treated as derivatives for U.S. federal income tax purposes because payments on a derivatives contract are sourced to the residence of the payee and U.S. withholding tax only applies to U.S. source payments. As a result, income under derivatives transactions for non-U.S. payees typically is treated as non-U.S. source and therefore not subject to U.S. withholding taxes. In the case of U.S. payees, generally no cross-border payments occur and no U.S. withholding tax applies (even though technically the payment would be U.S. source income). However, withholding under the Foreign Account Tax Compliance Act (“*FATCA*”) can apply to certain derivatives payments (although, as a practical matter, *FATCA* rarely applies as most foreign financial institutions and derivatives counterparties are compliant with their obligations to provide information about U.S. account holders to the relevant tax authorities). In addition, payments pursuant to a derivatives contract that are “dividend equivalent payments” may be subject to U.S. withholding tax (including withholding under *FATCA*). The standard ISDA Master Agreement contains specific provisions that allocate withholding tax responsibility between payor and payee, and commonly included ISDA protocols allocate the responsibility of withholding on “dividend equivalent payments” and *FATCA* withholding. Withholding tax may apply to payments of interest in certain cases but often can be avoided.

As indicated in the response to question 6.1 above, certain transactions documented as derivatives may be treated as something other than a derivatives contract for U.S. federal income tax purposes. Withholding obligations may apply to these types of transactions depending on the applicable rules for the type of transaction. For example, interest on a secured loan technically is subject to withholding, but the “portfolio interest exception” usually will apply to eliminate the need to withhold on interest payments. Additionally, certain non-U.S. payees may be eligible for reduced rates of withholding pursuant to an applicable income tax treaty.

6.3 Are there any relevant taxation exclusions or exceptions for certain classes of derivatives?

No, but see the response to question 6.2 above regarding sourcing of payments under derivatives to the residence of the payee.

7 Bespoke Jurisdictional Matters

7.1 Are there any material considerations that should be considered by market participants wishing to enter into derivatives transactions in your jurisdiction? Please include any cross-border issues that apply when posting or receiving collateral with foreign counterparties (e.g. restrictions on foreign currencies) or restrictions on transferability (e.g. assignment and novation, including notice mechanics, timings, etc.).

No jurisdiction-specific cross-border issues should apply, including with respect to the receipt of foreign currencies (see

also the response to question 5.4 above). However, market participants should give due consideration to cross-border issues of general application such as sanctions laws, counterparty due diligence, variations in customer asset protection rules, anti-money laundering regimes, etc. The conditions applicable to a transfer or novation of OTC derivatives are typically determined in accordance with the contractual provisions negotiated between the parties in the ISDA Master Agreement or applicable trade confirmations. Conversely, regulatory protections for certain transfers without the need for counterparty consent exist, including for transfers of derivatives transactions (and other qualified financial contracts) by the FDIC under its orderly liquidation authority from a failing GSIB to a solvent bridge entity, or for the porting of customer positions from an insolvent FCM to another FCM under the CFTC’s commodity broker liquidation rules.

8 Market Trends

8.1 What has been the most significant change(s), if any, to the way in which derivatives are transacted and/or documented in recent years?

The Dodd-Frank Act and related rulemaking ushered in a comprehensive regulatory regime for swaps, altering the way in which OTC derivatives markets can be accessed and used by various market participants. As the new regulations and compliance requirements helped mitigate trading and counterparty credit risk, the overall cost for entry into the derivatives market likely has increased as a result.

8.2 What, if any, ongoing or upcoming legal, commercial or technological developments do you see as having the greatest impact on the market for derivatives transactions in your jurisdiction? For example, developments that might have an impact on commercial terms, the volume of trades and/or the main types of products traded, smart contracts or other technological solutions.

U.S. derivatives markets will continue to see impactful legal and commercial developments in the near future. Market participants will need to prepare for the phasing-in of the remaining stages of initial margin requirements. As entities with \$50 billion and \$8 billion in AANA are brought into scope in 2021 and 2022, respectively, new margin rule-compliant documentation must be negotiated and custodial relationships established. The impending effective date for most security-based swap rules in 2021 will significantly progress the regulatory overhaul of the post-financial crisis swaps markets in the United States. The scheduled cessation of publication of USD LIBOR settings after December 31, 2021 (for the one-week and two-month settings) and June 30, 2023 (for the Overnight, one-, three-, six-, nine- and 12-month settings) alongside other IBOR benchmark rates globally is giving rise to the development of robust fallback language for benchmark replacements in the amended 2006 ISDA Definitions and the new 2021 ISDA Interest Rate Derivatives Definitions due for publication in October 2021, as well as the widespread adoption of the ISDA 2020 IBOR Fallbacks Protocol to permit the uplift of legacy transactions to the new amended standard.

On the commercial side, ESG-related (environmental, social and governance) derivatives are on the rise. Following a broader

trend in the financial markets supporting a transition to a more sustainable economy, derivatives instruments such as emissions trading, sustainability-linked derivatives and ESG-sensitive credit default swaps combine new ESG pricing aspects and methodologies with conventional derivatives technology. Similarly, cryptocurrency-referencing derivatives are increasingly gaining traction as a new asset class as new entrants into the derivatives markets seek to develop solutions to permit broader trading of cryptocurrencies and to increase related margin efficiencies. Furthermore, development of smart contracts, such as via ISDA's ISDA Create platform, is expected to drive negotiation of more standardized derivatives contracts to electronic platforms and streamline post-trade processes, real-time valuations and margin calls. The trend toward further standardization of trading contracts continues.



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