

Legal & Regulatory Update

Claude Brown

11 May 2010

C L I F F O R D
C H A N C E

WRMA AGM
Miami Beach

Overview

- ***Documentation***
- Regulation
- Accounting & Disclosure
- Information
- Case law

Documentation – Weather Derivative Confirmations

- “Weather Index Derivative Transaction” confirmations
 - Drafted by WRMA
 - Documentation suite now expanded to cover
 - HDD and CDD
 - Precipitation
 - Critical Days (CCDDs, CHDDs and Precipitation)
 - Calls & Puts
 - Caps & Floors
 - Drafting changes reduce the number of confirms needed from 18 to 6
 - Adopted by ISDA - to be added to the next revision of the ISDA Commodity Derivatives Definitions.

Documentation – “Burn Methodology”

- “Protocol” wording has been circulating in the market since the late nineties
- Didn’t fit ISDA Credit Support terminology
- Assumed only one weather derivative transaction to be collateralised
- Assumed no other derivatives under the same ISDA Master
- “Buffer” applied to both historic and actual data

“Burn Methodology” – WRMA Project

- Conform wording to ISDA Credit Support terminology
 - New York, Japanese and English law
 - CSA, CSD and Margin Provisions
- Amend buffer methodology
 - Only applied to historic values
 - Not applied to Fixed Payments or Marked Value Amounts
 - SD Multiple is an elective variable
- Introduction of “Net Exposure” concept
 - Buffer applied to both buyer and seller for forwards/swaps
 - Adjusts asymmetrically to favour the ITM party proportionately
- Global Adjustment Factor retained

“Burn Methodology” - Next Steps

- Take comments from WRMA membership on single transaction methodology
- Roll out for multiple transaction ISDA Masters
- Allow for compartmentalisation and integration of weather derivative transactions under the CSA
- Integrate into ISDA’s collateralisation review

Overview

- Documentation
- ***Regulation***
- Accounting & Disclosure
- Information
- Case law

Derivative Regulation – Key Areas

- Central Counterparty Clearing (CCPs)
- On exchange trading
- Collateralisation of OTC transactions
- End user requirements
- Transaction and position reporting

US Regulation

- Senate Agriculture Committee passed a Bill (“Lincoln bill”) “To improve the regulation of swap and security-based swap activities, and for other purposes”
- Senate Banking Committee passed a Bill (“Dodds bill”) Derivatives section is a “place holder”
- Collateralisation requirements apply to Swap Dealers and Major Swap Participants

US Regulation (2)

■ Substance of proposals:

- Swaps dealers and major swap participants are required to register with the CFTC or SEC;
- Swaps that are eligible to be cleared must be cleared through a clearing organization and must be traded through an exchange or execution facility
- Collateralisation of OTC swap positions
- Increased transaction reporting

EU Regulation

- Draft report on “Efficient, Safe and Sound Derivatives Markets: Future Policy Actions”
- Underlying philosophy
 - Pricing should reflect risks and costs – should be borne by users, not taxpayers
 - No more light touch regulation
 - Increased transparency and market efficiency
 - Reduce default risk and operational risk
- Creation of European Securities and Markets Authority (ESMA)

EU Regulatory Proposals (2)

■ Central counterparty clearing (CCP)

- Process of encouraging/forcing standardisation of derivatives to enable CCP
- Penalties for OTC trades which cannot be centrally cleared – e.g. collateralisation, transaction taxes
- Must be at least one European CCP; not owned by financial institutions

■ Exchange trading

- Not just formal securities exchanges
- Electronic trading platforms, etc.

EU Regulatory Proposals (3)

■ Collateralisation

- Will be used to encourage/force exchange trading and CCP
- No competition between CCP entities on collateral – ie, no “race to the bottom”
- Mandatory collateralisation for OTC derivatives
 - Higher collateral requirements than for CCP
 - Has caused controversy amongst “end users”

■ Transaction reporting

- Primarily focused on OTC transactions
- ESMA to establish common reporting standards

Market Abuse Directive and MiFID

■ Review of MiFID

- CESR to provide EC with technical advice by July 2010
- 3 consultation papers
 - Investor protection and intermediaries
 - Transaction reporting
 - Equity Markets

■ Reform of the Market Abuse Directive

- EC initiated a review in April 2009
- Public consultation April to June 2009
- No report as yet
- Impact on commodities

Overview

- Documentation
- Regulation
- ***Accounting & Disclosure***
- Information
- Case law

IAS 39 and IFRS 9

- Insurance contracts (IFRS 4) – require payment only if a particular level of an underlying climatic variable adversely affects the contract holder
- Derivative contracts (IAS 39) – require payment only based on a specified level of the underlying climatic variable regardless of whether an adverse effect on the contract holder

Hedge Accounting

- If derivative and on balance sheet item are classed as “hedge effective” then dealt with under the hedge accounting rules of IAS 39 – both items measured at fair value
- Currently weather derivatives do not qualify for hedge accounting because not “hedge effective”
- IASB is replacing IAS 39 with IFRS 9 and reviewing hedge accounting requirements

SEC's Interpretative Guidance

- Published Release 33-9106 on 2 February 2010
- Not “new” or a revision - intended to be clarificatory
- 3-2 vote
- Not intended to be SEC expressing a stance on climate change
- Intended to ensure rules are consistently applied
- Response to requests from institutional investors and investment groups

Release 33-9106

- Guidance will apply to disclosures in annual 10-Ks
- Climate change disclosure
 - Legislation & regulation
 - International accords
 - Indirect consequences
 - Physical effects of climate change

Release 33-9106 (cont'd)

- Regulation S-K for domestic issuers and Form 20-F for foreign private issuers
- Item 101 – description of the companies business
- Item 103 – legal proceedings
- Item 503 – risk factors
- Item 303 - MD&A

Release 33-9106 and the Weather

- Property damage and disruption to operations including transportation
- Indirect effects of disruptions to customers and suppliers
- Increased insurance claims and liabilities
- Decreased agricultural production
- Increased premia and deductibles, reduced coverage

Overview

- Documentation
- Regulation
- Accounting & Disclosure
- ***Information***
- Case law

Directive 2003/98/EC

- Directive was reviewed by the Commission in May 2009
- Communication from the Commission on the Re-use of Public Sector Information (COM/2009/0212)
- PSI Directive was implemented by MS after considerable delay
- No amendments proposed at this stage
- Further review in 2012

Overview

- Documentation
- Regulation
- Accounting & Disclosure
- Information
- ***Case law***

The Bliski Case

35 U.S.C. 101 Inventions patentable.

- Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefore, subject to the conditions and requirements of this title.
- Historically assumed that business methods were not patentable

Court of Appeals for the Federal Circuit in State Street Bank & Trust Co. v. Signature Financial Group, Inc., 149 F.3d 1368 (1998)

- Upheld a patent on a software program that was used to make mutual fund asset allocation calculations
- Also established the “useful, concrete and tangible result” test for patentability

The Bliski “Patent”

- A method for managing the consumption risk costs of a commodity sold by a commodity provider at a fixed price comprising the steps of:
 - initiating a series of transactions between said commodity provider and consumers of said commodity wherein said consumers purchase said commodity at a fixed rate based upon historical averages, said fixed rate corresponding to a risk position of said consumer;
 - identifying market participants for said commodity having a counter-risk position to said consumers; and
 - initiating a series of transactions between said commodity provider and said market participants at a second fixed rate such that said series of market participant transactions balances the risk position of said series of consumer transactions.

Bliski – the history

- 1997 Bernard L. Bilski and Rand A. Warsaw file a patent application
- Rejected by the Examiner:
 - *“The invention is not implemented on a specific apparatus and merely manipulates [an] abstract idea and solves a purely mathematical problem without any limitation to a practical application, therefore the invention is not directed to the technological arts.”*

Appealed to the Board of Patent Appeals and Interferences

■ Board said:

- Examiner wrong to rely on “technological arts” test
- A process not performed using a machine could still be statutory if it transformed physical subject matter from one state to another

But

- Transformations in the application were of non-physical financial risks and legal liabilities
- Directed to an abstract idea
- Did not produce a “useful, concrete and tangible result.”

Appealed to U.S. Court of Appeals for the Federal Circuit

- A mental process that was not implemented by a machine or other tangible object
- Method did not transform any article to a different state or thing
- Legal obligations, such as options and futures contracts and business risks cannot meet the test for patentability
- Purely mental process of performing mathematical calculations
- Discarded “useful, concrete and tangible result” test

Appealed to the Supreme Court- Bilski v. Kappos

- *“Whether the [CA] erred by holding that a “process” must be tied to a particular machine or apparatus, or transform a particular article into a different state or thing (“machine-or- transformation” test), to be eligible for patenting under 35 U.S.C. 101”?*
- *“Whether the [CAs] “machine-or-transformation” test for patent eligibility, which effectively forecloses meaningful patent protection to many business methods, contradicts the clear Congressional intent that patents protect “method[s] of doing or conducting business.” 35 U.S.C. 273.”?*

Legal & Regulatory Update

C L I F F O R D
C H A N C E

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

© Clifford Chance LLP 2010

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications

UK-2429556-v1