



# International Securitization & Finance Report

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*A Twice-monthly Review of Innovative Tax-Effective and Asset-Backed Financing Transactions*

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## Implications to Derivatives Users of the Dodd-Frank Wall Street Reform and Consumer Protection Act

BY MARC A. HORWITZ, DAVID KROHN  
AND JAY TAYLOR (DLA PIPER LLP, US)

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). Title VII of Act, entitled "Wall Street Transparency and Accountability", contains a sweeping overhaul of the regulation of over-the-counter ("OTC") derivatives markets that, according to industry estimates, exceed \$400 trillion in outstanding notional amount.

Most of the provisions of Title VII become effective on July 16, 2011 (the "Effective Date"), which is 360 days after the July 21, 2010 enactment of Title VII, although certain provisions are effective immediately upon enactment and in many instances additional rules and regulations must be adopted in order to implement the legislation. In such instances, the effective date of the relevant

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## European Debt and Global Currency Chaos: *Understanding and Managing the Risk*

BY DR. F. JOHN MATHIS  
(THUNDERBIRD SCHOOL OF GLOBAL MANAGEMENT),  
WOLFGANG KOESTER AND COREY EDENS (FIREAPPS)

The growing foreign debt problems in Europe, combined with a variety of dramatic global economic and political upheavals, has led to unprecedented global currency volatility and growing economic uncertainty. As economists contemplate the prospect of a break-up of the euro, an unpegging of the Chinese renminbi to the U.S. dollar, and the possibility of a second global economic crisis (centered this time in Europe), what should companies do to understand their exposure and protect corporate value from foreign currency risk?

MATHIS: The euro crisis raises some serious issues about Europe. We have definitely learned that it is not like the United States. It is not the 'United

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#### Dodd-Frank Act to Overhaul OTC Derivatives Markets in U.S.

The Act aims to fundamentally change the way OTC derivatives are traded in the U.S. and gives unprecedented powers to the US Commodity Futures Trading Commission. Some key provisions likely to affect dealers and end-users are explained. *Page 1*

#### Understanding and Managing Risk amidst Euro Crisis

When there is volatility in the euro, the likelihood of achieving earnings per share target are reduced. As earnings seasons approaches, corporations will have unexpected foreign exchange results. *ISFR* explores how managers can better understand their company's exposures in a timely fashion. *Page 1*

#### Transfer Pricing Beyond Tax Department

Changes to transfer pricing rules, IRS and European enforcement practices and developments in related areas of the law have made transfer pricing a critical issue for more than the corporate tax department. The location of high value functions is gaining importance in determining the transfer prices charged among operating affiliates. *Page 3*

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In 2008, the EC institutionalized a settlement procedure in which parties would be allowed to assess the Commission's evidence against them and make settlement submissions based on a range of fines. A recent case settlement demonstrates the procedure's potential benefits. *Page 5*

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## Global Currency Chaos, from page 1

Countries' or the 'United States of Europe,' and we are going to explain why that problem puts the euro and Europe in a very precarious position and will end up causing currency problems for a long time.

We had the birth of the euro back on January 1, 1999. There were a small number of countries that were members at that time, and it was a transition. It was not a quick movement into a euro common currency because the governments wanted to set the stage to have a very stable currency, and they used a European currency unit to try to accomplish that over several years.

In any event, what they were able to do was set up a European Central Bank to control monetary policy throughout the area. What they were not able to do was set up a common federally oriented fiscal management system. So, you have a centralized monetary control system required not only to stabilize the euro among all the member countries but also to oversee the management of monetary policy in the area.

The fiscal policy is a different story. It is managed by each individual country, so there is a natural conflict. That is the big difference from the United States, where we have a common central bank, monetary policy and a common fiscal policy for all states. So in Europe, the taxing authority and the spending authority become country-based. That is what created the issue with respect to Greece.

### Actions Speak Louder Than Words

Breaches in fiscal policy guidelines have been repeated over the years whenever countries get into trouble, and some of the countries have run into some pretty serious issues. An issue to consider is whether these budget deficits are domestically financed or in-

ternationally financed. If they are internally financed the problem is a little bit less serious. However, as soon as a budget deficit becomes an externally funded issue, as in the case of Greece, then there is a linkage to other member countries in the European area, and that becomes a problem for other European member countries.

Historically, because of the juxtaposition between managing monetary and fiscal policy and external factors that influence the euro area, there has been a significant degree of volatility in the value of the euro. In September 2008, we begin to move into a different issue: the global economic crisis, which precipitated by financial problems beginning in the United States was transferred to the UK and then further transferred globally. As a result, the euro zone went into a deep decline in growth. Because they have a common monetary policy, it was easier to manage for all of the countries but somewhat removed from individual country economic differences. Consequently, individual countries looked to their own governments and elected officials who would like to stay elected to solve their problems. As a result, individual governments were pressured into issuing a lot more debt and a lot more borrowing. There was greater stimulation using fiscal policy to try to insulate the individual member country from the degree of downturn in the global economy. In the euro area general government debt rose very rapidly as a percent of GDP -- especially in selected countries like Greece, Spain, Portugal, and Ireland.

### Greek Debt Forces The Eurozone to Take Action

It did not take long before several countries were up to a huge amount of debt outstanding. There are

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## Transfer Pricing Beyond the Tax Department

BY NATHANIEL CARDEN  
(SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP)

**For many multinationals, the intercompany transfer prices charged among affiliates have long been solely the concern of the tax department, with possible input from the customs and supply chain functions. However, changes in transfer pricing rules,<sup>1</sup> IRS and European enforcement practices and developments in related areas of the law have made transfer pricing an important issue for senior management, commercial teams and legal departments.**

### Emphasis on Strategy and Functions

Many large multinationals have traditionally managed their transfer pricing structures by relying principally on economic investment principles. U.S.-based multinationals, in particular, would often look to the economic investments made by overseas affiliates to support those affiliates' tax ownership of valuable intellectual property (IP) and subsequent rights to significant income from that IP. Tax authorities (especially in the U.S.) also placed great weight on these investments. This emphasis was a natural response to concerns about mismatched income and deductions that motivated many of the changes in the U.S.'s approach to intangibles-related transfer pricing in the 1980s.

In principle, these investments remain critically important. However, both U.S. and European transfer pricing enforcement look increasingly at people, not just dollars. Specifically, the location of high-value functions such as R&D, licensing, business development, manufacturing and marketing are becoming increasingly significant, both in determining the transfer prices charged among operating affiliates and in defending these positions. The IRS may seek documents, and even interviews, with commercial teams, manufacturing personnel and researchers.

### Intellectual Property Defense

Among the most significant developments in transfer pricing has been the emergence of case law illustrating the potential impact of intercompany agreements on a company's ability to defend its intellectual property. Since 2001, a number of high-profile patent decisions have highlighted how the intercompany licensing that is central to transfer pricing can, if not managed correctly,

compromise a company's ability to protect its patents.<sup>2</sup> These cases illustrate two related problems: standing and damages. In summary, these cases have held that patent owners and related, exclusive licensees have standing to sue infringing parties, but non-exclusive licensees do not. Furthermore, where non-exclusive licensees lack standing, the patent owner's recovery may be limited to reasonable royalties—even though the entity seeking injunctive relief or lost profits damages is part of the same wholly-owned corporate family as the patent owner.

**Both U.S. and European transfer pricing enforcement look increasingly at people, not just dollars.**

In order to ensure their operations comply with transfer pricing rules, multinational companies often must license their intellectual property to corporate affiliates. Frequently, these licenses are prepared by tax departments attempting to comply with transfer pricing and other tax rules. Several courts, including the Federal Circuit,<sup>3</sup> have squarely held that the rules of patent standing apply to intercompany licensing arrangements, meaning that nonexclusive licensing relationships (a common feature in many intercompany pricing structures) can inhibit a company's ability to recover lost profits or seek injunctive relief.

### Growth and M&A: When Transfer Pricing Especially Matters

It is, of course, always important for a multinational company to ensure that its transfer pricing supports both its strategic commercial priorities and other legal positions. However, these issues become critically important whenever a company undertakes a significant strategic or operational change. Investments in organic growth create both planning opportunities and controversy risks as the functions performed by various affiliates change. This is especially true for companies that are expanding in emerging markets, since many

**continued on page 4**

# Transfer Pricing

*Beyond the Tax Department, from page 3*

of these organic growth initiatives will be located in (and focus on) these markets.<sup>4</sup> Appropriate structuring of intercompany pricing relationships can allow companies to retain substantially more of the value they create in these markets, while, conversely, missteps will create significant audit exposures.

**Recent tax and other legal developments have made transfer pricing an important issue for commercial executives and legal departments, in addition to tax professionals.**

M&A activity, particularly a sizeable acquisition, creates an even greater challenge, since the acquiring company inherits the target's transfer pricing structure and intercompany licenses. This creates the obvious risk that the acquiring and target companies' positions will be used against one another as evidence of transfer pricing errors. However, the less obvious and more significant problem is that the target's transfer pricing structure may, if not properly adapted for the acquirer's needs, create other legal and operational complications. For example, many patent protection problems arise because of poor integration of acquired products into the acquirer's existing transfer pricing structure.

### Conclusion

Recent tax and other legal developments have made transfer pricing an important issue for commercial executives and legal departments,

in addition to tax professionals. Transfer pricing policies that are inconsistent with corporate operations cause significant audit risk, while intercompany agreements that are ambiguous or create non-exclusive relationships can compromise IP protection. Thoughtful coordination among tax professionals, business leaders and law departments can prevent these problems, but care must be taken up front—once an issue is revealed on audit or in litigation, it is usually too late. □

<sup>1</sup>See, e.g., Treas. Reg. § 1.482-7T and -9 (governing Qualified Cost Sharing arrangements and related party services transactions, respectively); Organization for Economic Co-Operation and Development (OECD), Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines (September 9, 2009); Discussion Draft on the Transfer Pricing Aspects of Business Restructurings (September 19, 2008).

<sup>2</sup>See, e.g., *Poly-America, LP v GSE Lining Technology, Inc.*, 383 F.3d 1303 (Fed Cir 2004); *Rhone-Poulenc Agro, S.A. v. DeKalb Genetics Corp.*, 271 F.3d 1081 (Fed. Cir. 2001).

<sup>3</sup>See, e.g., *Poly-America LP*, 383 F.3d at 1301-11 (holding that patent holder could not recover lost profits damages for related corporate entity since the common parent corporation "has arranged their corporate identities and functions to suit its own goals and purposes [and so] it must take the benefits with the burdens.").

<sup>4</sup>See, e.g., Edwards, Michael, R&D in Emerging Markets: A New Approach for a New Era, McKinsey Quarterly February 2010.

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## First Antitrust Settlements Reached with European Commission

BY CLIVE STANBROOK OBC QC AND JOSEPH F. WINTERSCHIED  
(MCDERMOTT WILL & EMERY LLP)

**The European Commission's new settlement procedure in antitrust cases offers potential benefits that can be significant.**

On May 19, 2010, the European Commission imposed its first set of fines under the new settlement procedure for antitrust cases in the DRAM investigation.

The Commission formally institutionalized a settlement procedure for antitrust cases in July 2008, the objective being to achieve procedural economy in straightforward cases. The Commission has complete freedom in choosing which cases can go to settlement and will write to parties asking whether they are interested in following the settlement procedure. If the parties accept the Commission's offer, they will be granted access to the Commission's file in order to assess the evidence against them. The object of this part of the settlement procedure is for the parties and the Commission to reach a "common understanding regarding the scope of the potential objections and the estimation of the range of likely fines." In practice, the Commission unilaterally communicates a range of fines determined by it, once a common understanding has been reached on the scope of the infringement. The Commission will then invite the parties to make settlement submissions formally requesting to settle the case, on condition that the fine imposed does not exceed the maximum of the range communicated by the Commission.

The benefits of the settlement procedure to the parties are not limited to the 10% fine reduction and reduced legal costs that flow from a simpler administrative procedure. Unless a company has a cast iron defense to the Commission's allegations, there is also considerable benefit in being able to have a dialogue with the Commission case team within the non-contentious atmosphere of a settlement procedure. The DRAM case illustrates that the parties were able to succeed on some very favorable claims under the 2006 Fining Guidelines and the 2006 Leniency Notice. All of the companies involved obtained the benefit of a month-by-month calculation of the duration of the fine, rather than semester by semester. In addition to full immunity for the "whistle-blower", another party

obtained partial immunity because it provided the Commission with information enabling the Commission to extend the investigation's product scope. The Commission accepted a reduction of the fine for mitigating circumstances in some cases where involvement in the infringement was partial or sporadic.

It should be emphasized that the Commission was not inclined to grant concessions just for the sake of making settlement procedures more attractive. The basis parameters of the calculations, namely the gravity and entry fee coefficients, as well as the deterrence multipliers, were generally in conformity with the Commission's published practice so far. The benefit of the settlement procedure, as illustrated in DRAM, is that the parties are able to have a complete and open discussion with the case team about the manner in which these parameters should be applied long before the matter (and the proposed level of fines) become public.

Lastly, the Commission was very sensitive to the concern that participation in the settlement procedure should not put the parties at a disadvantage vis-à-vis third parties with respect to possible third party claims. For this reason the Commission showed great flexibility in accepting oral statements, in the same way as it does with respect to leniency applications.

Clearly not all cases are suitable for settlement, and the pros and cons will need to be carefully weighed in each individual case. The result reached in the DRAM matter, however, demonstrates that in appropriate cases, the Commission's settlement procedure offers potential benefits that can be very significant. □

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**It should be emphasized that the Commission was not inclined to grant concessions just for the sake of making settlement procedures more attractive.**

# Foreign Exchange

## Pacific Exchange Rate Services Exchange Rates for the Dollar as of July 28, 2010

The table below gives the rates of exchange for the U.S. dollar against various currencies as of July 28, 2010. All currencies are quoted in foreign currency units per U.S. dollar except in certain specified areas. All rates quoted are indicative. They are not intended to be used as a basis for particular transactions. Pacific Exchange Rate Services (<http://pacific.commerce.ubc.ca>) does not assume responsibility for errors.

	Currency	Value of U.S. Dollar	Country	Currency	Value of U.S. Dollar	Country	Currency	Value of U.S. Dollar
Afghanistan	Afghani	46.24	Georgia	Lari	1.837	Norfolk Islands	Aus. Dollar	1.1186
Albania	Lek	104.58	Germany	Euro*	1.2987	Norway	Krone	6.1517
Algeria	Dinar	73.896	Ghana	Cedi	1.443	Oman Sultanate	Rial	0.385
Andorra	Euro*	1.2987	Gibraltar	Br. Pound*	1.5599	Pakistan	Rupee	85.615
Angola	Kwanza	90.49	Greece	Euro*	1.2987	Panama	Balboa	1.00
Antigua	E.Car. \$	2.7	Greenland	Dan. Krone	5.7368	Papua N.G.	Kina	2.6954
Argentina	Peso	3.9314	Grenada	E.Car. \$	2.7	Paraguay	Guarani	4785.00
Armenia	Dram	371.04	Guadeloupe	Euro*	1.2987	Peru	Nuevo Sol	2.8225
Aruba	Guilder	1.79	Guam	US\$	1.00	Philippines	Peso	45.815
Australia	Dollar	1.1186	Guatemala	Quetzal	8.0355	Pitcairn Island	NZ Dollar	1.3735
Austria	Euro*	1.2987	Guinea Republic	Franc	5050.00	Poland	Zloty	3.0905
Azerbaijan	Manat	4606.50	Guinea Bissau	CFA Franc	504.89	Portugal	Euro*	1.2987
Azores	Euro*	1.2987	Guyana	Dollar	204.70	Puerto Rico	US\$	1.00
Bahamas	Dollar	1.00	Haiti	Gourde	39.73	Qatar	Riyal	3.6395
Bahrain	Dinar	0.377	Heard/McDonald Is.	Aus. Dollar	1.1186	Rep. Yemen	Rial	229.14
Bangladesh	Taka	69.425	Honduras	Lempira	18.895	le de la Reunion	Euro*	1.2987
Barbados	Dollar	2.00	Hong Kong	Dollar	7.7663	Romania	Leu	3.2771
Belarus	Ruble	2976.00	Hungary	Forint	218.16	Russia	Ruble	30.265
Belgium	Euro*	1.2987	Iceland	Krona	120.98	Rwanda	Franc	588.39
Belize	Dollar	1.95	India	Rupee	46.766	Samoa (American)	US\$	1.00
Benin	CFA Franc	504.89	Indonesia	Rupiah	9005.50	San Marino	Euro*	1.2987
Bermuda	Dollar	1.00	Iran	Rial	9995.70	Sao Tome/Principe	Dobra	18773.00
Bhutan	Nguitrum	46.766	Iraq	Dinar	1169.00	Saudi Arabia	Riyal	3.7502
Bolivia	Boliviano	7.020	Ireland	Euro*	1.2987	Senegal	CFA Franc	504.89
Bosnia Herzegovina	Konv. Marka	1.456	Israel	New Shekel	3.8035	Serbia/Montenegro	Yug. N. Dinar	N/A
Botswana	Pula	6.8376	Italy	Euro*	1.2987	Seychelles	Rupee	12.408
Bouvet Island	Krone	N/A	Jamaica	Dollar	85.650	Sierra Leone	Leone	3928.60
Brazil	Real	1.7677	Japan	Yen	87.68	Singapore	Dollar	1.3664
Brunei	Dollar	1.3646	Johnston Island	US\$	1.00	Slovakia	Koruna	23.194
Bulgaria	Lev	1.5067	Jordan	Dinar	0.709	Slovenia	Tolar	N/A
Burkina Faso	CFA Franc	504.89	Kazakhstan	Tenge	147.67	Solomon Is.	Solomon\$	7.9066
Burundi	Franc	1230.90	Kenya	Shilling	80.6	Somali Rep.	Shilling	1604.30
Cameroun	CFA Franc	504.89	Kiribati	Aus. Dollar	1.1186	South Africa	Rand	7.3636
Canada	Dollar	1.0316	Korea, North	Won	1.18	Spain	Euro*	1.2987
Cape Verde Islands	Escudo	84.575	Korea, South	Won	1184.20	Sir Lanka	Rupee	112.54
Cayman Islands	Dollar	0.82	Kuwait	Dinar	0.2878	St. Helena	Br. Pound*	1.5599
Cent. Af. Republic	CFA Franc	504.89	Kyrgyzstan	Som	46.65	St. Kitts	E. Car. \$	2.7
Chad	CFA Franc	504.89	Laos	Kip	8233.00	St. Lucia	E. Car. \$	2.7
Channel Islands	Br. Pound*	1.5599	Latvia	Lat	0.546	St. Pierre/Miq'lon	Euro*	1.2987
Chile	Peso	520.08	Lebanon	Pound	1506.80	St. Vincent	E. Car. \$	2.7
China	Renminbi	6.7778	Lesotho	Maloti	7.3636	Sate of Cambodia	Riel	4241.00
Christmas Islands	Aus. Dollar	1.1186	Liberia	Dollar	72.50	Sudan	Dinar	N/A
Cocos Islands	Aus. Dollar	1.1186	Libya	Dinar	1.2778	Suriname	Dollar	2.745
Columbia	Peso	1849.90	Liechtenstein	Sw. Franc	1.0586	Swaziland	Lilangeni	7.3636
Comoros Rep.	Franc	378.28	Lithuania	Litas	2.6587	Sweden	Krone	7.2993
Congo Republic	CFA Franc	504.89	Luxembourg	Euro*	1.2987	Switzerland	Franc	1.0586
Congo Dem Rep.	Franc	N/A	Macau	Pataca	8.0001	Syria	Pound	46.63
Costa Rica	Colon	520.11	Macedonia	Dinar	43.91	Taiwan	Dollar	32.028
Cote d'Ivoire	CFA Franc	504.89	Madagascar	Franc	8547.00	Tajikistan	Somoni	N/A
Croatia	Kuna	5.58	Madeira	Euro*	1.2987	Tanzania	Shilling	1509.70
Cuba	Peso	1.00	Malawi	Kwacha	151.47	Thailand	Baht	32.255
Cyprus	Pound	0.45	Malaysia	Ringgit	3.1900	Togo Rep.	CFA Franc	504.89
Czech Repub.	Koruna	19.215	Maldives Is.	Rufiyau	12.800	Tokelau	NZ \$	1.3735
Denmark	Krone	5.7368	Mali Republic	CFA Franc	504.89	Tonga Island	Pa'anga	1.91
Djibouti	Franc	177.72	Malta	Lira	0.3306	Trinidad/Tobago	Dollar	6.3
Dominica	E.Car. \$	2.7	Martinique	Euro*	1.2987	Tunisia	Dinar	1.4625
Domi. Rep.	Peso	36.56	Mauretania	Oguiya	284.00	Turkey	Lira	1.513
Dronning Maud.	Nor. Krone	6.1517	Mauritius	Rupee	30.399	Turkmenistan	Manat	14250.00
East Timor	US\$	1.00	Mexico	New Peso	12.693	Turks & Caicos	US\$	1.00
Ecuador	US\$	1.00	Moldova	Lei	12.27	Tuvalu	Aus. Dollar	1.1186
Egypt	Pound	5.703	Monaco	Euro*	1.2987	Uganda	Shilling	2241.00
El Salvador	Colon	8.7475	Mongolia	Tugrik	1356.50	Ukraine	Hryvnia	7.8907
Eq'tl Guinea	CFA Franc	504.89	Montserrat	E.Car. \$	2.7	United Kingdom	Br. Pound*	1.5599
Eritrea	Nafka	13.63	Morocco	Dirham	8.5726	Uruguay	Peso	20.94
Estonia	Kroon	12.048	Mozambique	Metical	35000.00	U.A.E.	Dirhan	3.6729
Ethiopia	Birr	13.637	Myanmar	Kyat	6.4323	Uzbekhistan	Som	1605.50
European EMU	Euro*	1.2987	Namibia	Dollar	6.99	Vanuatu	Vatu	100.54
Faeroe Islands	Dan. Krone	5.7368	Nauru Is.	Aus. Dollar	1.1186	Vatican City	Euro*	1.2987
Falkland Islands	Br. Pound*	1.5599	Nepal	Rupee	74.82	Venezuela	Bolivar	4.29
Fiji	Dollar	1.9139	Neth. Antilles	Guilder	1.79	Vietnam	Dong	19048.00
Finland	Euro*	1.2987	Netherlands	Euro*	1.2987	Virgin Islands BR	US\$	1.00
Fr. Pacific Islands	Franc	91.692	New Zealand	Dollar	1.3735	Virgin Islands US	US\$	1.00
France	Euro*	1.2987	Nicaragua	Cordoba	21.419	West Samoa	Tala	2.34
French Guiana	Euro*	1.2987	Nieue	NZ Dollar	1.3735	Zambia	Kwacha	4920.00
Gabon	CFA Franc	504.89	Niger Rep.	CFA Franc	504.89	Zimbabwe	Dollar	N/A
Gambia	Dalasi	26.950	Nigeria	Naira	150.25			

(N/A) Not Available \* U.S. Dollar per national currency unit

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# Snapshots

BY REUTERS

## China

### Slow Inflows Herald Shift in China Central Bank Operations

A slowdown in capital inflows to China suggests a lasting tightening in liquidity conditions that will keep money market rates high and may force the central bank to replace its draining operations with fund injections.

Official data show that curbs put in place to cool the booming property sector and a slumping stock market have markedly cut into the volumes of foreign exchange pouring into the country.

That means that the People's Bank of China is buying fewer currencies than in the past decade and consequently injecting fewer yuans into the banking system.

Economists do not expect a quick reversal of the trend, which means that the liquidity crunch in the past two months, blamed on a series of capital raising by banks and large equity offers, will not be just a passing phenomenon.

The central bank and Chinese institutions spent only 117 billion yuan (\$17 billion) to absorb foreign exchange flowing into China in June, the Position for Forex Purchases report showed.

The figure, the lowest since the worst of the global crisis in November 2008, was well below first half average of 214 billion, according to Reuters calculations.

The data also showed China's capital inflows reached their peak in early 2008 and have since decreased generally despite occasional spikes in some months.

## Dubai

### Dubai World Ready to Use Tribunal For Debt Deal

Struggling state firm Dubai World is ready to use a special tribunal to force rebel lenders into line on plans to delay repayment of \$14.4 billion in debts. The ambitious Gulf Arab emirate is labouring under more than \$100 billion of debts including those of its flagship conglomerate. "It's unlikely all 73 banks will accept terms, which means it will likely go to a tribunal," the source said, adding that if the majority support the plan, the tribunal can compel holdouts to get in line so the restructuring can proceed. Dubai set up the special tribunal to be arbiter of disputes between lenders and the stricken state company. A deal has already been agreed with core lenders representing 60 percent of the loans.

## Japan

### Sumitomo Arranges Japan's First Islamic Funding Deal

Sumitomo Corp is arranging the first Islamic funding deal in Japan, which could pave the way for other Japanese issuers to tap the \$1 trillion industry, a source with knowledge of the deal said.

The yen-denominated issue mirrors the structure of Islamic bonds but is not strictly sukuk as Japan's banking regulations do not provide for such an offering.

**Sumitomo Corp is arranging the first Islamic funding deal in Japan, which could pave the way for other Japanese issuers to tap the \$1 trillion industry.**

The issue would follow a recent \$100 million Islamic bond sale by Japan's top brokerage Nomura Holdings in Malaysia, and reflects growing interest by the Asian economy in shariacompliant financing.

The deal is expected to be signed in the third quarter and the issuance amount has yet to be finalised. The issue would be underpinned by a series of sale and purchase transactions to meet the sharia's requirement that financing deals have to involve specific assets.

## UK

### UK M&A Watchdog Has Slowest Year Since 1994

Britain's takeover watchdog had its slowest year since 1994, it said on Wednesday, highlighting the depth of the recent slowdown in mergers and acquisitions involving UK companies. In its annual report, the Takeover Panel said it dealt with 90 takeover or merger proposals for the year ended March 31, down from 104 proposals a year earlier. It was the lowest since 1994, when there were 81, and the third-lowest year since 1970. But it said the relatively quiet year for deals was offset by disciplinary actions.

## US

### FASB Hires Expert to Review How New Rules Perform

The Financial Accounting Standards Board, **continued on page 8**

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### **Snapshots, from page 7**

which writes U.S. accounting rules, said on Wednesday it had hired an accounting expert to lead reviews of the board's new rules and standards after they have been implemented. Mark Schroeder, a recently retired senior partner at Deloitte & Touch, will serve as the board's first "post-implementation review leader" and also serve a similar role for the Governmental Accounting Standards Board, FASB said.

The hiring of Schroeder is one of the big steps that FASB has taken to formalize its process for review of how new standards are performing. Banks and investors had complained during the financial crisis that FASB's new rules on mark-to-market accounting had contributed to freezing the credit markets, but there was no formal process for reviewing the rules.

In 2008, a financial reporting advisory committee to the U.S. Securities and Exchange Commission recommended that FASB formalize a process for reviewing the effects of accounting changes after the changes had taken effect. The new review process could face a big test in the next few years, as the

FASB and IASB expect to complete major projects to align about a dozen key areas of accounting by the end of 2011.

The London-based International Accounting Standards Board (IASB) has also pledged to undertake post-implementation reviews of its major rule changes.

### **U.S. Watchdog Warns on Foreign Auditor Use**

The U.S. accounting watchdog warned auditors about relying on foreign consultants to review company financial statements. U.S.-based auditors that are issuing audit reports based on work performed outside the United States are not adhering to U.S. standards, the Public Company

Accounting Oversight Board (PCAOB) said. The PCAOB, which was created in response to accounting scandals at Enron and WorldCom, said it found that a U.S. audit firm issued a report on a Chinese company without traveling to the area or properly reviewing the audit work of its Chinese consultants. The PCAOB did not identify the U.S. auditor. □

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## **Financial Regulation**

### **Implications to Derivatives, from page 1**

provision is 60 days after publication of a final rule or regulation implementing such provision.

The Act aims to fundamentally change the way OTC derivatives are traded in the United States and gives unprecedented powers to the US Commodity Futures Trading Commission (the "CFTC") in order to achieve that result. Under the Act, the CFTC has jurisdiction over all "swaps"<sup>1</sup>, subject to limited exclusions, including an exclusion for "security-based swaps"<sup>2</sup>, which are under the jurisdiction of the US Securities and Exchange Commission (the "SEC"). The Act expressly requires the CFTC and SEC to coordinate with each other and the relevant prudential regulators before commencing any rulemaking or issuing any order. According to recent estimates, the majority of outstanding OTC derivatives by notional amount would fall under the exclusive jurisdiction of the CFTC. Therefore, the CFTC has primary jurisdiction over the currently composed marketplace for OTC derivatives.

Set forth below are some of the key provisions of the Act relating to OTC derivatives that are likely to significantly affect dealers and end-users alike.

### **Mandatory Clearing**

The Act requires all swaps to be submitted for clearing to a registered derivatives clearing organi-

zation ("DCO") or a DCO that is exempt from registration unless an exemption from the mandatory clearing requirement exists. Exemptions from the clearing requirement currently include the following but are subject to adjustment during the rulemaking process.

### **End-User Exemption**

The end-user exemption applies if a party (i) is not a "financial entity"<sup>3</sup>, (ii) is using swaps to hedge or mitigate commercial risk, and (iii) properly notifies the CFTC or SEC, as applicable, how it meets its financial obligations associated with entering into non-cleared swaps. The end-user exemption is available at the option of the party that meets the foregoing three criteria.

### **Financial Entity**

In order to qualify for the end-user exemption, a non-financial, non-pension end-user (a "Corporate End-User") cannot be a major swap participant (an "MSP") or, in the case of security-based swaps, a major security-based swap participant (an "MSBSP"; MSPs and MSBSPs are sometimes collectively referred to as "major participants"). A Corporate End-User will not be an MSP or an MSBSP as long as:

(A) it does not maintain a "substantial position" in swaps for any category determined by the

CFTC or SEC except “positions held for hedging or mitigating commercial risk”; and  
(B) its outstanding swaps do not create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.

The CFTC and SEC will define the term “substantial position” in upcoming rulemakings taking into account a party’s “relative position in uncleared as opposed to cleared swaps” and possibly the value and quality of collateral held against counterparty exposures. Notably, earlier versions of the legislation referred to a “substantial net position” in swaps, implying that Congress expects the CFTC and SEC to consider aggregate, rather than net, positions in its upcoming rulemakings.

No rulemaking is required for the methodology of determining systemically important institutions. Therefore, it is unclear how a Corporate End-User or regulator should evaluate whether its positions could threaten US financial stability.

### **Hedging or Mitigating Commercial Risk**

No rulemaking is required on what constitutes “hedging or mitigating commercial risk.” Therefore, there is no guidance on how to determine whether a transaction constitutes a hedge or mitigation of risk. In addition, it is unclear as to what risks are “commercial” in nature and what risks fall under some other category. Market participants likely will request that the CFTC and/or SEC provide guidance to the market regarding the scope of this exemption. In the absence of guidance, market participants may take a conservative approach to determining which swaps satisfy these requirements.

### **CFTC/SEC Notification**

Parties relying on the end-user exemption will need to closely watch the relevant rulemaking regarding the manner in which a party seeking the exemption must notify the CFTC or SEC how it generally meets its financial obligations associated with uncleared swaps. It is not clear whether the CFTC or SEC may require clearing following a determination that a party fails to meet yet unstated CFTC or SEC criteria for meeting uncleared swap obligations. This requirement may provide the CFTC or SEC with an opportunity to require collateral for some or all uncleared swaps where one party is not a dealer or major participant.

### **Regulators’ Exemption**

The Act requires the CFTC, on an ongoing basis,

to “review each swap, or any group, category, type, or class of swaps to make a determination as to whether the swap or group, category, type or class of swaps should be required to be cleared.” The SEC has a corresponding duty for security-based swaps. In addition, DCOs are required to submit to the relevant regulator those swaps they plan to accept for clearing. Based on its independent review and DCO submissions, the relevant regulator will make a determination as to whether swaps, or groups, categories, types or classes of swaps are required to be cleared. In making its determination, such regulator will consider factors such as exposures, liquidity, pricing data, clearing infrastructure, the effect on systemic risk, clearing fees and the treatment of positions, funds and property in a DCO insolvency. After the regulator makes a determination following a DCO submission, a party to a swap may petition the relevant agency to review the clearing requirement for the petitioned swap(s). The Act requires rulemakings on the entire review process to be completed not later than July 21, 2011.

**Swap participants with the ability to move trading to offshore locations may consider the jurisdictional reach of the Act; the provision potentially could encourage derivatives trading to migrate to less regulated foreign markets.**

### **Grandfather Exemption**

Swaps and security-based swaps entered into before July 21, 2010 are not required to be cleared as long as they are reported to a registered swap data repository or to the CFTC or SEC within 180 days after such date. Swaps and security-based swaps entered into before the clearing mandate is effective are exempt if reported to a registered swap data repository or to the CFTC or SEC within 90 days after the Effective Date or such later time as may be determined by the CFTC or SEC.

### **Non-Clearable Exemption**

If a swap is subject to the mandatory clearing requirement, the swap must be executed on (i) a board of trade designated as a contract market under the Commodity Exchange Act or (ii) a swap execution facility that is registered under the Commodity Exchange Act or is exempt from registration thereunder. The foregoing requirement does not apply if no board of trade or swap execution facility will list the swap.

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## Reporting

All swaps are subject to real-time reporting of price and volume as required by CFTC rule, regardless of whether those swaps are subject to mandatory clearing. The CFTC may require swap dealers, MSPs and/or other entities registered with the CFTC to disseminate the reported data publicly. The CFTC will make rules (a) to ensure that publicly reported information does not identify the participants, (b) to specify the appropriate time for reporting of large notional trades, (c) to determine what constitutes a large notional trade, and (e) that consider whether market liquidity will be materially and adversely affected by public reporting. Reporting of uncleared swaps must be made to registered data repositories or, if no such repository will accept the swap, to the CFTC pursuant to CFTC rule. Additional reporting rules apply to swaps that the CFTC determines to be significantly large as to perform a significant price discovery function with respect to registered entities. Security-based swaps will be subject to similar reporting rules to be administered by the SEC.

## Pre-existing Swaps

Section 729 of the Act provides that swaps entered into before July 21, 2010 and outstanding on such date must be reported to a registered swap repository or the CFTC not later than 30 days after the CFTC issues an interim final rule or such other period set by the CFTC. Such interim final rule shall be promulgated within 90 days of July 21, 2010. Section 723(a)(5)(A) of the Act provides that the CFTC shall make a rule that swaps entered into before July 21, 2010 shall be reported to a registered swap repository or the CFTC not later than 180 days after the Effective Date. These provisions appear to overlap and therefore create uncertainty as to the actual reporting requirements for pre-existing swaps. The CFTC may adopt rules or otherwise may provide guidance to clarify the uncertainty. The SEC will make similar reporting rules that will apply to security-based swaps.

## Post-Act Swaps

Section 723(a)(5)(B) of the Act provides that the CFTC shall make a rule that swaps entered into on or after July 21, 2010 shall be reported to a registered swap repository or the CFTC not later than 90 days after the Effective Date or such later time the CFTC may prescribe by rule or regulation. The SEC will make similar reporting rules that will apply to security-based swaps.

## Who Must Report

If only one party to an uncleared swap is a registered dealer or major participant, only the dealer

or major participant must report. If one party is a dealer and the other is a major participant, only the dealer must report. In all other cases, the parties shall select one party for reporting.

## Non-trade Reporting

Swap dealers and MSPs also must file periodic reports as required by CFTC rule or regulation regarding their swap positions and financial condition. Security-based swap dealers ("SBSDs") and MSBSPs are subject to periodic reporting requirements as required by SEC rule or regulation.

## Registration

Swap dealers and MSPs must register as such with the CFTC and must submit periodic reports as the CFTC may prescribe. The CFTC will make rules regarding registration of swap dealers and MSPs by July 21, 2011. SBSDs and MSBSPs must register as such with the SEC and must submit periodic reports as the SEC may prescribe. Swap dealers and MSPs that also are SBSDs or MSBSPs must register separately with the CFTC and SEC and comply with the requirements established by each agency.

## Capital

The CFTC, the SEC and/or (in the case of banks) the applicable prudential regulator will prescribe minimum capital requirements for swap dealers, SBSDs, MSPs and MSBSPs. Capital requirements will be determined in accordance with perceived risk, such that presumably registered entities that enter into uncleared swaps will face higher capital requirements than registered entities in the same category that enter into similar cleared swaps.

## Margin

The CFTC, the SEC and/or (in the case of banks) the applicable prudential regulator will prescribe minimum initial and variation margin requirements on uncleared swaps entered into by swap dealers, SBSDs, MSPs and MSBSPs, regardless of whether the other party is also one of the foregoing registered entities. These margin requirements expressly apply only to such registered entities, and not to other parties.

The Act does not include language from the last draft of the Conference Committee Report exempting both parties from initial and variation margin requirements for uncleared swaps where one party is not a swap dealer or MSP. Therefore, in an uncleared swap between a swap dealer or MSP and a Corporate End-User, the swap dealer or MSP would be obligated to satisfy margin requirements while the Corporate End user apparently would not face legally mandated margin requirements. In

Parties relying on the end-user exemption will need to closely watch the relevant rulemaking regarding the manner in which a party seeking the exemption must notify the CFTC or SEC how it generally meets its financial obligations associated with uncleared swaps.

a June 30, 2010 letter to Representatives Frank and Peterson of the House Financial Services Committee and House Agriculture Committee, Senators Dodd and Lincoln stated that the Act “does not authorize the regulators to impose margin on end users.” However, the appropriate regulators may have the authority to prohibit swap dealers or MSPs from entering into transactions with end users who do not post collateral in order to “help ensure the safety and soundness of the swap dealer or major swap participant.” In addition, the CFTC could decline to approve a swap for a clearing exemption unless both parties, including the non-dealer or non-MSP, post collateral in an amount determined by the CFTC. In any case, the Act appears to mandate that end users accept margin from counterparties that are dealers or MSPs.

### Record Keeping

Swap dealers and MSPs must keep books and records as required by their prudential regulators or the CFTC as prescribed by CFTC rule or regulation and must maintain daily trading records including such information as prescribed by CFTC rule or regulation. SBSBs and MSBSPs have corresponding record keeping requirements that are administered by the SEC in accordance with SEC rule or regulation.

### Business Conduct/Special Entities

Swap dealers and MSPs also must comply with business conduct standards set by CFTC rule or regulation. SBSBs and MSBSPs also must comply with business conduct standards set by SEC rule or regulation. Business conduct standards may relate to fraud, manipulation, abusive offering and sales practices, supervision, position limits, and dealings with “special entities”. “Special entities” include ERISA plans, governmental plans, endowments, state and local governments and federal agencies. The special requirements for dealers and major participants that are counterparties to non-governmental special entities will be set forth in rules and/or regulations subsequently promulgated by the relevant regulator. In addition, the Act provides that a dealer who acts as an advisor to a special entity must act in the best interests of the special entity and use reasonable efforts to obtain sufficient information in order to make that determination. Further, dealers and major participants that are parties to swaps with governmental special entities must comply with applicable rules that require the dealer or major participant to satisfy certain due diligence and disclosure requirements.

### Segregation

#### Dealer Notification

A swap dealer, SBSB, MSP or MSBSP must notify

its counterparty at the beginning of a transaction that the counterparty has the right to require segregation of all collateral except “variation margin”. Although the term “variation margin” is not defined, it could mean that, in the context of an ordinary New York law 1994 ISDA Credit Support Annex, the right to request segregation exists in respect of amounts posted as Independent Amounts but not amounts posted based on changes in Exposure.

#### Use of Custodians

Segregated collateral must be held with an independent third party custodian in a segregated account for and on behalf of the counterparty.

**If only one party to an uncleared swap is a registered dealer or major participant, only the dealer or major participant must report. If one party is a dealer and the other is a major participant, only the dealer must report. In all other cases, the parties shall select one party for reporting.**

#### Reporting if Segregation Not Elected

If the counterparty does not require segregation, the swap dealer, SBSB, MSP or MSBSP must provide a quarterly report to the counterparty that the registered entity’s back office procedures comply with the terms of the agreement between the parties relating to collateral.

#### Swaps Desk Pushout

The final version of Section 716 of the Act, commonly referred to as the swaps desk “pushout rule”, prohibits “federal assistance” to certain types of swap dealers and MSPs; provided that insured depository institutions may receive “federal assistance” if (a) their swap activities are limited to hedging and similar risk mitigating activities and/or (b) they are acting as swap dealers or MSPs in connection with swaps involving rates or assets that are permissible for investment by a national bank<sup>4</sup> (other than uncleared credit default swaps). “Federal assistance” means use of advances from a Federal Reserve credit facility or discount window for the purpose of lending to, or purchasing any stock, equity interest or debt obligation, or the assets, of a “swaps entity”, guaranteeing debt to a swaps entity, or entering into any assistance arrangements with a swaps entity.

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## *Implications to Derivatives, from page 11*

A “swaps entity” is a swap dealer, SBSBSP, MSP, or MSBSP that is registered with the CFTC or SEC but does not include an MSP or MSBSP that is an insured depository institution. The swaps desk “pushout rule” does not prevent insured depository institutions that are part of bank holding companies from having affiliates that are swaps entities, meaning that banks can “push out” their trading desks for the enumerated products to affiliates and still receive “federal assistance”. Swap dealers have two years from the Effective Date to consult with the applicable regulators and determine whether to divest, spin off or move to nonbanking affiliates certain trading businesses. At this stage, it is unclear whether swap dealers will in fact move their equity derivatives, energy, agricultural commodity and other relevant trading desks to affiliates or will simply choose not to receive “federal assistance”. In any case, banks will need to comply with the “Volcker Rule” on proprietary trading, which rule is part of the Act but does not appear in Title VII.

**Segregated collateral must be held with an independent third party custodian in a segregated account for and on behalf of the counterparty.**

### **Jurisdiction/ Non-US Swap Participants**

Swap participants with the ability to move trading to offshore locations may consider the jurisdictional reach of the Act. In general, the Act does not apply to non-US activities relating to swaps unless those activities have a direct and significant connection with activities in, or an effect on, US commerce or contravene CFTC rules or regulations preventing evasion. The Act does not apply to non-US activities relating to security-based swaps unless the SEC otherwise has jurisdiction or the activities were designed to evade SEC rules or regulations related to the Act. The CFTC and SEC will conduct a joint study relating to swap regulation and central clearing in the US, Asia and Europe and report its findings to Congress within 18 months after July 21, 2010.

If the CFTC or SEC determines that the regulation of swaps or security-based swaps in any foreign country undermines US financial stability, either agency, in consultation with the Secretary of Treasury, may prohibit an entity domiciled in that country from engaging in any swap activities in the

US. This provision potentially could exclude certain swap participants from the US market if US agencies are not satisfied with the progress of the efforts of foreign regulators to regulate markets outside the US. Alternatively, the provision could encourage derivatives trading to migrate to less regulated foreign markets. □

1 The Act defines “swap” broadly to include virtually all OTC derivatives, including foreign exchange transactions. However, the Secretary of the Treasury is charged with determining whether foreign exchange swaps and foreign exchange forwards (which are defined broadly and may include certain transactions generally considered to be spot transactions) should not be regulated as swaps (other than for purposes of the Act’s reporting requirements and business conduct standards). Currency options are not expressly included as part of the category of foreign exchange products for which the Secretary of the Treasury is charged with making a determination.

2 The Act defines “security-based swap” to include swaps based on narrow-based security indices, a single security or loan, or the occurrence of an event relating to a single issuer of a security or a narrow-based security index. Equity derivatives and some credit derivatives are likely to be classified as security-based swaps, although market participants will look to the CFTC and SEC for guidance where ambiguity exists.

3 A “financial entity” includes swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, commodity pools, private investment funds, ERISA plans, and persons predominantly engaged in banking or financial activities. Exceptions exist for affiliates who enter into derivatives in order to hedge commercial risks related to the purchase or lease of products manufactured by such affiliated entities.

4 Permissible investments for national banks generally are considered to include debt instruments, foreign exchange, and certain precious metals but not equity securities, energy products or agricultural commodities.

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## **Global Currency Chaos, from page 2**

two types of outstanding foreign debt: one is the government issued debt, which is related to fiscal stimulative policies to insulate the economy from recession; the other is private sector debt.

Private companies needed to get access to outside funds to avoid being pulled under with the downturn in economic activity. Greece had borrowed dramatically and became the first to slip into a tipping point. It's estimated that they currently have about \$500 to \$540 billion in total public and private debt (government and corporate debt) held by foreign countries. High levels of debt with reduced real GDP growth (aggravated by depressed shipping and tourism foreign currency earnings) created a serious debt service problem. Greece now has huge ongoing annual debt servicing requirements. In 2010, even before the problem began, they had accumulated \$60 billion plus in debt servicing requirement. With the downturn in world trade, their shipping revenue fell by almost 50% and tourism revenue also declined. These two sources account for between 50 to 60 percent of Greece's annual GDP and is a major source of foreign currency earnings. Greece, therefore, became the first country to be financially challenged and consequently targeted for capital flight. The fiscal spending that the government tried to initiate became curtailed. The country was not receiving financial inflows to service the debt, setting the stage for a default. What was the euro area going to do? The euro zone members, with the support of Germany, finally did come up with a trillion dollar rescue package to both guarantee member government's external debt as well as the bank's external debt.

### **Pigs in Debt: A Tangled Web That Traps All of Europe**

#### ***Portugal, Italy, Ireland, Greece And Spain***

The banks inside the euro zone member countries present another issue, and that is that they hold substantial Greek debt. Almost half of Greek debt is owned by French banks, which are partially owned by the French government. Consequently, there is now an issue that if Greece defaults, that would put stress on the French banks and the government. Germany is the next largest holder of Greek debt, which puts more stress on Germany, and a similar counterparty foreign debt service risk ripples through the other countries of Europe. Spain, Portugal and Ireland are in a similar situation to that of Greece, and, again, most of the European debt – particularly the corporate debt that has been issued externally – is held by banks in the European zone.

Therefore, there is a lot of counterparty risk building throughout the Euro area. This suggests that as each of the weaker countries go through their

particular foreign debt restructuring problem, other countries in the euro zone will also suffer, resulting in continuous currency crises well beyond the current year ahead. The World economy will remain under stress with many countries facing huge debts and debt service payments. Several IMF forecasts suggest that the budget deficit as a percent of GDP or debt service as a percent of GDP may change little over the next decade. These are vulnerable countries and will continue to put pressure on the euro.

**If the governments do not pursue expansionary fiscal policy – or if they do and then implement offsetting restrictive monetary policy – economic activity in Europe will decline.**

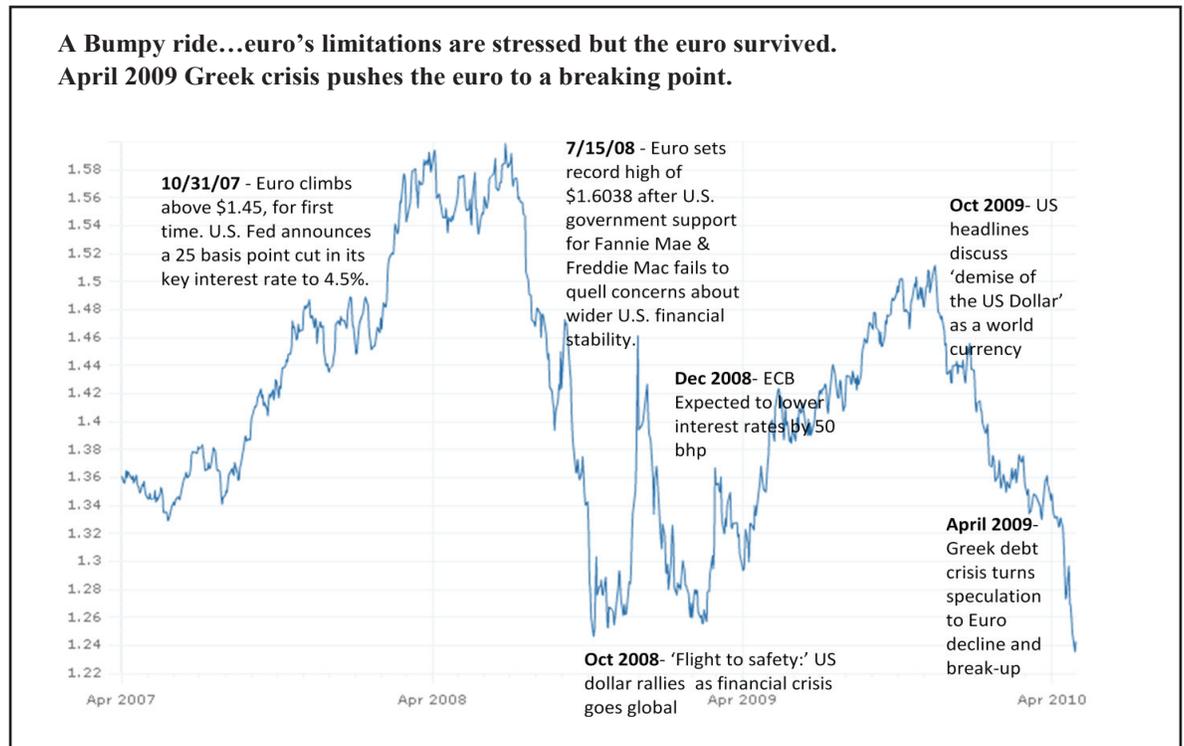
### **Resulting in Debt and Deficits Across The Euro Zone**

The UK has a very high per capita foreign debt outstanding. Even though it's not a member of the euro, it trades heavily with primarily European countries. Consequently, there is a substantial amount of counterparty risk that is not at first evident, and this is going to continue to perpetuate a crisis environment. There is a huge increase in debt in industrial countries with the Euro countries way beyond their 3 percent fiscal debt limit required as a condition of Euro membership. Fiscal policy management right now inside the euro area is out of control. This raises concern about whether there will be a euro going forward. There is a vicious circle that Europe is caught in right now: increase debt service, rising government debt, higher interest rates, slower economic growth, stimulus to more spending, and debt and debt service are rising. If the governments do not pursue expansionary fiscal policy – or if they do and then implement offsetting restrictive monetary policy – economic activity in Europe will decline. Such a slowdown adversely impacts the U.S. as well as emerging markets. Consequently, this is not a European specific problem; it is a very broad global problem.

### **The European Problem is Becoming Global**

In addition to what is going on in Europe, there are emerging hot spots in other countries. We now have a growing amount of global uncertainty, like a second wave of slow down, or fear, of economic recession spreading throughout the world. There is spreading news of both political and economic problems. We have BP and the oil spill in the Gulf of Mexico as an issue which has strained U.S.-U.K.

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**Even though it appeared that we were out of the crisis mode for a while, one can see that now in mid-2010, we are already beginning to see the signs of problems re-emerging. If growth does slow, it will have a very significant impact on corporations' growth and profitability prospects.**

relations. We have North and South Korea arguing about who sunk the South Korean ship killing almost 50 sailors. There are problems in China and the government is now talking about revaluing the Yuan. All of a sudden U.S. imports from China may falter if the U.S. does not continue to recover, which may be adversely affected if Europe slows down. If Europe's growth does soften, imports from China may slow further, which means that China's export growth is not going to grow as strongly as we thought. That is going to have negative implications not only for China but also for the rest of developing Asia as well as Australia and New Zealand.

Even though it appeared that we were out of the crisis mode for a while, one can see that now in mid-2010, we are already beginning to see the signs of problems re-emerging. If growth does slow, it will have a very significant impact on corporations' growth and profitability prospects.

**WOLFGANG:** We are looking at the way the money was spent in Europe to stimulate the economies, and this is why one can see huge rises in volatility. Certainly the euro, in our opinion, is not going to be where it is today in 18 months. There will be a different set of constituents and a different value. In the next 12 to 18 months, we will see some great trigger points with Greece.

The obvious place where people can look at the valuation of companies is in income statements. So, as foreign exchange impacts the income statement, it does so on a lot of different lines. Above the line, summing up to the net operating income, you have

revenues being less predictable. What are the costs of goods sold? What are the operational expenses? These are true economic impacts. This ends up in the bottom line. Either you got money or you didn't. If you sold something for 100 euros a few months ago, you would have received 160 dollars; now you get 120 dollars, and that is what is impacting your bottom line. When you have volatility, it reduces the likelihood of achieving your earnings per share target. Less predictability in earnings per share creates less shareholder value. People get nervous about that happening.

If managers have unexpected foreign exchange gains or losses, they may be signaling that there is a lack of risk management expertise: perhaps a lack of visibility to certain risks, or less predictable margins, or less predictable net income. Nevertheless, as companies start to get into earnings seasons, a lot of corporations will have unexpected foreign exchange results, and that is going to create additional volatility in the equity market.

**MATHIS:** The International Monetary Fund (IMF) recently came out with a report that indicates that the government budget deficit issue is a serious one that will be ongoing; that it is not just a one-time shot, and that it is potentially going to have a significant negative impact on corporations in the future. Consequently, getting through a quarter does not mean that corporations have resolved their funding and financial issues.

**WOLFGANG:** On an annual basis, we survey Fortune 500 global companies and look at mate-

rial FX gains or losses. We found that 59 percent of companies surveyed are experiencing serious foreign exchange losses. That is up almost 50 percent from 2008. So, that is certainly an indication, and I believe that that trend is not going away. The issue then becomes: how does this impact my company?

Companies are continuously trying to get a better understanding of their exposures, not only accurately but also timely. Timeliness in these volatile markets is becoming much more crucial.

**MATHIS:** Timeliness becomes increasingly important when there is greater volatility because Europe is so interlinked with other economies; the counterparty risk will spill over into the U.S. and therefore into countries as far away as Australia and New Zealand.

**COREY:** Part of managing the risk is being able to understand the exposures at the end of the day. With increased volatility comes increased risk. So, international footprints are expanding. Companies have to be able to understand where the data resides in their systems. They have to be able to get that data out of their systems quickly and efficiently. They have to be able calculate and understand their exposure. Executives must do a risk assessment and ultimately make a decision. In the past, when volatility was lower, especially with certain currencies, there was more time to make decisions. Today, companies have to be able to make those decisions faster with better information.

### Ups and Downs Always Occur

At the end of the day, companies are more vulnerable. One consideration is that companies' exposures are getting larger, because they are either

growing organically or they are growing through M&A activity. Today, in our global economy, everything is interrelated, so debt is interrelated. All the different components of the economic environment, from assets to liability, are interrelated, and that causes a lot more complexity.

**Companies are continuously trying to get a better understanding of their exposures, not only accurately but also timely. Timeliness in these volatile markets is becoming much more crucial.**

**MATHIS:** It used to be that international trade was what linked us together, but now what is much more important than international trade are the financial interlinkages that are expanding. The liberalization of banking systems, money markets, and capital markets has tied our economies closer together from a financial globalization perspective, and that is what is transferring a certainty in volatility much more rapidly than in the past.

### There is No Longer A "Free Pass" For Unanticipated FX Impacts

**COREY:** At the end of the day, there is no more free pass. That's what we're seeing in the market today. Over the last five years, there has been much greater awareness across the entire chain of counterparties and stakeholders in this whole corporate world. And as companies grow internationally, they

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## Global Currency Chaos, from page 15

are building a portfolio of risk, a pool of exposure, that is very complicated. As companies grow and get up in the revenue chain, there might be thousands of rows of data that actually make up their exposure at any given point in time. Some companies are building their understanding of how currencies impact their business in a very complex and interrelated world.

### FX Will Have a Significantly Greater Impact on Corporate Financial Performance Than it Has in the Past

**COREY:** So what do companies need to do? They need to leverage technology, tools, and power, and they need to work harder and smarter. Maintaining the current course is not the right strategy. Companies have to decide if they want to continue to accept the risk or do something about it. The organization and its stakeholders have to understand the tolerance that they have for risk, and they should seek alignment across all pieces of the organization, looking outside in and inside out.

**MATHIS:** So, small exposure times a large volatility means big exposure.

**WOLFGANG:** Big risk. Companies must educate their shareholders and constituents about what risks they taking, and then, say, 'this part of the risk I am willing to take, and this part I am not.'

**COREY:** Companies are beginning to step back and look at their risk management policies and determine the individual risks involved in the currency relationships that they have, so that they can make

informed decisions on managing risk as opposed to managing exposure.

### Solution: Understand Your True Economic and Accounting Exposure

The key is that companies need to understand their exposure. They have to build that understanding by not only looking at it once but continuously. They have to understand their exposure more methodically and more frequently, both above the line and below the line. Companies need to be careful about what surprises are lurking below the surface.

The fact is that companies have to be able to get data out of their systems. They have to be able to get at the underlying transactions that comprise their risk to currencies across the enterprise. They have to be able to get into an environment where they can understand that exposure, assess the risk in it, and make a decision. On the one hand, if manage is willing to accept the risk, that is a decision that he is going to make periodically, by reviewing that decision once a quarter with the boards. On the other hand, if manage decides that he wants to reduce the risk, then the company must decide how. Are you actively doing it, are you going to look back into your operations and try to take steps to reduce the risk by changing business transaction flows and entity structures? Companies will be able to look outside by using derivatives as well. So, those are all part of risk reduction strategies that firms are putting into place.

### Key Takeaways

The world is changing. It is more interrelated. We have a lot of economies that are impacting corporates and corporate transaction flows around the world. Therefore, there is a lot more risk involved today. Volatility is causing a lot more effects and unpredictability.

So firms must be aware that the old rules no longer apply. They have to understand their risk and be able to make decisions faster. Finally, the old tools and processes aren't sufficient any longer. There is complex system landscape; the data is embedded in a lot of business systems around the world. Companies must discern how to get at the information, how to make decisions, and how to continue to press forward. □

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