MEMORANDUM

TO: Katherine Tew Darras

FROM: Tom Prevost
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DATE: August 23, 2010

RE: HIRE Act Protocol

Background

The HIRE Act, enacted in the US on March 18, 2010, would impose US withholding tax on certain payments referred to as "dividend equivalent payments," effective for payments made on any swap after September 14, 2010, regardless of when the swap was entered into. In general, "dividend equivalent payments" include payments under an equity swap that are determined in part based on dividend payments on a referenced US equity security. Depending on their terms and other circumstances, typical equity swap transactions are potentially subject to the withholding requirements imposed by the HIRE Act. For example, if a non-US counterparty buys or sells the underlying reference security from its counterparty (crosses in or crosses out), the dividend equivalent swap payment will be subject to US withholding tax. Moreover, the statute also causes all cross border dividend equivalent payments on equity swaps to be subject to US withholding tax beginning March 18, 2012, unless the US Department of the Treasury writes regulations to exempt swaps with certain characteristics from the withholding requirement.

This memorandum summarizes the substantive changes to ISDA Master Agreement and Schedule that would be made by the HIRE Act Protocol that ISDA is publishing today (the "Protocol"). The Protocol provisions are the product of extensive discussions among members of the North American Tax Committee ("NATC"), members of ISDA's legal documentation group, interested members of the Managed Funds Association ("MFA") and counsel retained by the MFA. The Protocol provisions primarily address the changes in law made by the HIRE Act. There also are certain changes to reflect the heightened tax risk resulting from the US Internal Revenue Service's ("IRS") ongoing audit activity of dealers and hedge funds with respect to equity swap transactions. We want to acknowledge that ISDA's European Tax Committee had expressed its preference to avoid US Internal Revenue Code section references in ISDA's primary documents. After considerable work to try to avoid doing so, the NATC concluded that the relevant US statutory provisions had so many specific requirements that there was no reasonable drafting approach that could be taken other than referring to those statutory provisions.

Summary of the Proposed Changes

No gross-up for withholding imposed under the HIRE Act statutory provisions

Under the Protocol (see Attachment Section 5), if US withholding is required by reason of the new statutory provisions, including the so-called FATCA provisions of the HIRE Act, the party required to make the withholding will not be required to pay a gross-up. Since the HIRE Act provisions require a party to remit tax whether or not that party is required to make a net payment that is sufficient to withhold the tax from, the Protocol (see Attachment Section 1) provides that a "withholding tax" includes these specific taxes that might be collected other than by withholding (i.e., by direct remittance to the IRS where the amount to be "withheld" exceeds the amount of any net payment to the relevant party). In this circumstance, the Protocol provides that the amount that is deemed to be withheld is added to the calculation of the net payment on the payment date that covers the period for which that amount arises. The Protocol contains language to ensure that the tax is taken into account only once. Therefore, if an amount of tax is actually withheld, it is not taken into account in computing any net payment called for by the Agreement, and if an amount is taken into account in computing a net payment called for by the Agreement, a party cannot make a claim for an indemnity under Section 2(d)(ii) of the Agreement for the same amount.

Payee representations

The Protocol (see Attachment Section 8) contains payee representations reflecting the HIRE Act. In one set of representations, the payee who would be the recipient of a "dividend equivalent payment" within the meaning of the HIRE Act states that the nature of the equity derivative transaction is not one that attracts the HIRE Act withholding tax, and otherwise states that the payee will not take other specified trading actions in connection with entering into the equity derivative transaction that market participants believe can cause the equity derivative transaction to become subject to withholding under the HIRE Act.

Other added representations address the FATCA provisions under the HIRE Act (IRC sections 1471 and 1472) that would subject payments made after December 31, 2012, to certain non-US persons to a 30 percent US withholding if those non-US persons do not satisfy certain as of yet undefined US information reporting requirements. The added payee representation, made by both parties, states that the payee will meet those requirements. This provision in the Protocol ensures that it is always the payee's responsibility for the US withholding tax under these new FATCA provisions, given it is within the payee's control as to whether they decide to comply with the new FATCA reporting requirements. We realize that some parties are concerned about making representations regarding these FATCA reporting provisions when it is still unclear what will be required to comply with these provisions. However, there are transactions being entered into now that will have payments occurring after December 31, 2012. Therefore it is important to clarify now that the payee has responsibility for any withholding taxes that could arise.

In addition, since the withholding tax rate on a dividend equivalent payment may be reduced under a double tax treaty, the Protocol (see Attachment Section 7) adds the "dividends" article to the list of treaty provisions with respect to which a party otherwise represents its eligibility.

Clarification of "Tax Event"

The IRS is aggressively auditing equity swaps entered into in the last several years with a view to asserting that one or more US payors (i.e., the party making a US dividend equivalent payment under an equity derivative transaction, which could be a non-US person such as a hedge fund or non-US swap dealer) of swap payments failed to withhold properly on those payments. The US payors would be liable to the IRS for any withholding taxes that they are found to have failed to withhold in the past and would be obligated to gross up for any payments subject to withholding going forward. The definition of Tax Event would allow a US payor in this situation to terminate a swap (at a Termination Amount on the counterparty's side of the market) if there is a "substantial likelihood" that it would be required to pay the gross up on the next scheduled swap payment date, "due to" an "action taken by a taxing authority." The Protocol (see Attachment Section 2) would refine the definition of Tax Event in a manner tailored to the current US audit environment. The Protocol would provide specifically that a written notice to a swaps dealer or a hedge fund from the IRS of an intention to assess tax on any US payor in connection with an equity swap can be considered to be a Tax Event for the recipient of the notice and others similarly situated.

Termination right for parties required to withhold on dividend equivalent payments

The Protocol (see Attachment Section 3) provides that if dividend equivalent payments on a transaction become subject to withholding under the HIRE Act provisions, either party generally would be able to terminate the swap (generally under the "Mutual Early Termination" provisions unless the applicable Confirmation provides for other optional early termination provisions). The main purpose of the provision is to avoid a situation where a payor is unable for systems or other operational reasons to comply with the HIRE Act withholding provisions, which are not yet clearly defined. At the same time, payees who do not otherwise have an optional early termination right, would be given the right to terminate a trade on which they would be receiving payments that are subject to withholding without being grossed up. In general, the added optional termination must be exercised within 18 months of the relevant action by a taxing authority that causes the withholding to be incurred takes place ,if the action occurs before March 18, 2012, and within three months of the relevant action if that action takes place on or after March 18, 2012. For this purpose, an action by a taxing authority is deemed to occur on September 13, 2010 (since the HIRE Act provisions become effective on the next day) and on March 18, 2012 (since inaction by the IRS will cause additional transactions to be covered by the HIRE Act as of that date). The terminating party generally is required to give at least 10 Exchange Business Days notice of the termination, although a shorter notice period is permitted in cases where withholding is required on transactions following an action by a taxing authority and the effective date of that withholding is shorter than 10 Exchange Business Days.

Effective date

With two exceptions, the provisions of the Protocol are effective as of the time the Protocol becomes effective between the parties (the Implementation Date). Accordingly, the provisions of the Protocol apply to all transactions that are outstanding on or entered into after the Implementation Date. However, the provisions clarifying the definition of Tax Event would only apply to transactions entered into after the Implementation Date. In addition, the added

payee representations would apply effective only after September 13, 2010, with respect to transactions entered into or outstanding after that date.

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