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THE 7% SOLUTION: STRUCTURED DIVIDEND RECEIVED DEDUCTION TRANSACTIONS FACE INTERNAL REVENUE SERVICE AUDIT SCRUTINY

WG&L

MARK LEEDS

THIS ARTICLE EXAMINES RECENTLY RELEASED AUDIT GUIDANCE FROM THE INTERNAL REVENUE SERVICE CHALLENGING THE RIGHT OF CORPORATE TAXPAYERS TO CLAIM DIVIDEND RECEIVED DEDUCTIONS IN VARIOUS TRANSACTIONS.

It appears that a 7% effective tax rate can have addictive properties to corporate taxpayers much in the same way that the 7% cocaine solution had to Sherlock Holmes in Nicholas Meyer's 1974 novel entitled, *The Seven Per-cent Solution*. Specifically, Section 243(c)(1) of the Internal Revenue Code of 1986, as amended (the "Code") provides corporate taxpayers who hold at least 20% of the outstanding stock of a U.S. corporation, determined by voting power and value, with a deduction equal to 80% of the amount of dividends received on such stock.[1] This deduction, referred to as the dividend received deduction or "DRD," currently lowers the effective tax rate on intercorporate dividends to 7%.[2] Recently, the Internal Revenue Service ("IRS") released three separate pieces of audit guidance in which the IRS challenged the right of corporate taxpayers to claim DRDs in various transactions. In the same way that the literary version of Dr. Sigmund Freud sought to keep Holmes away from his 7% solution, the IRS appears to be on a similar mission against corporate taxpayers that have structured into their 7% solution. This article describes and analyzes these developments.

FIELD ATTORNEY ADVICE 20131701F (RELEASE DATE APRIL 26, 2013)

FAA 20131701F addressed the financial plumbing behind a DRD structured transaction. It's an interesting piece of authority because it analyzes certain Code § 1258 conversion transaction issues and does not directly address DRD issues. In the front end of the transaction, a parent corporation ("Parent") that filed a consolidated federal income tax return with a corporation that had losses ("Subsidiary") purchased 80% of the common stock of a newly-formed corporation called "Special Purpose Vehicle" or SPV. A financial institution ("Bank") purchased the remaining 20% of the SPV common stock. Bank also purchased a substantial amount of SPV preferred stock.[3] The SPV preferred stock was stock described in Code § 1504(a)(4), sometimes referred to as "plain vanilla preferred." The plain vanilla preferred stock did not affect whether Parent and SPV were members of the same affiliated group eligible to file a consolidated federal income tax return.[4] Parent sold a call option to Bank which would allow Bank to purchase the 80% of the SPV common stock held by Parent.

The Transactions Among the Parties

SPV then lent the monies that it received as capital contributions to Subsidiary, as more fully described below. The FAA recites that SPV did not expect to incur a tax liability on the interest accrued or paid on this loan because SPV believed that it could shelter its income with Subsidiary's pre-existing losses. If SPV and Subsidiary had been members of the same affiliated group filing a consolidated federal income tax return, this result would have occurred.[5] The FAA states that in separate advice the IRS had concluded that the fact that Parent granted a call option on the SPV stock to Bank prevented SPV and Subsidiary from being considered part of the same affiliated group.[6]

Subsidiary used the loan proceeds that it received from SPV to prepay its obligations under a forward contract with a non-U.S. subsidiary of Subsidiary ("Euro International"). The prepaid forward contract required Euro International to deliver a portfolio of high grade corporate bonds to Subsidiary.[7] The delivery date under the forward contract corresponded to the 5-year due date of the note issued by SPV to Subsidiary in exchange for the cash loan. In general, Subsidiary could satisfy its obligations under the loan from SPV by delivering the bonds that it would receive from Euro International, instead of repaying such loan in cash. Thus, if the reference bonds fell in value, SPV (and ultimately, Bank, who owned substantially all of SPV through the plain vanilla preferred stock[8]) would bear this loss. For this reason, the loan from SPV to Subsidiary was referred to as a "credit linked note."

The prepaid forward contract between Subsidiary and Euro International had a feature that, in the absence of a default on a bond in the portfolio, ensured that Subsidiary would earn a profit on the transaction. Specifically, all interest paid on the portfolio during the duration of the forward contract was to be invested in additional bonds that would be delivered to Subsidiary at the termination of the forward contract. Accordingly, if the forward contract was respected as such and the bond portfolio remained valued at par, Subsidiary could expect a gain on its position equal to all interest that accrued on the bonds during the duration of the contract.

Given that Subsidiary would not receive current payments on the forward contract with Euro International, a mechanism was needed to provide Subsidiary with cash flow to make interest payments on the credit linked note. Accordingly, Subsidiary and Parent entered into an unusual 5-year interest rate swap. Under this swap, Parent made periodic payments to Subsidiary equal to the product of the par amount of the credit linked note and the LIBOR-based interest rate thereon. These payments were equal to the payments that Subsidiary needed to make interest payments on the credit linked note it issued to SPV. The timing of these payments also matched the timing of the interest payments under the

1 The determination of whether a corporate shareholder holds at least 20% of the outstanding stock of a U.S. corporation is made without considering stock described in Code § 1504(a)(4).

2 35% (the maximum corporate tax rate) x 20% = 7%.

3 It appears that the preferred stock issued to Bank bore a fixed rate.

4 See Code § 1504(a)(4).

5 See Treasury Regulation § 1.1502-11(a).

6 See Treasury Regulation § 1.1502-4(b)(2).

7 It was unclear as to whether the bonds deliverable under the prepaid forward contract could be fixed rate bonds, floating rate bonds or both. The forward contract specified only that the bonds had to have a yield at least equal to U.S. dollar LIBOR.

8 The plain vanilla preferred stock likely constituted the overwhelming majority of the capitalization of SPV. As a result, any losses would be borne by Bank as the holder of such stock.

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credit linked note. In exchange for this stream of payments, Subsidiary was required to make a single payment to Parent equal to a fixed rate per annum (and compounded at a LIBOR-based rate) at the maturity of the swap. Subsidiary would be able to satisfy this delayed delivery obligation when it received payment from Euro International under the forward contract.

SECTION 243(C)(1) OF THE INTERNAL REVENUE CODE OF 1986, AS AMENDED, PROVIDES CORPORATE TAXPAYERS WHO HOLD AT LEAST 20% OF THE OUTSTANDING STOCK OF A U.S. CORPORATION, DETERMINED BY VOTING POWER AND VALUE, WITH A DEDUCTION EQUAL TO 80% OF THE AMOUNT OF DIVIDENDS RECEIVED ON SUCH STOCK.

Parent entered into a 5-year fixed-to-floating interest rate swap with Euro International. The notional amount of this swap was equal to the principal amount of the credit linked note. Under this swap, Parent paid the product of the notional amount and a fixed interest rate. In exchange for these payments, Euro International paid the product of a floating rate and the same notional amount.

SPV then entered into a third 5-year fixed-to-floating interest rate swap with another non-U.S. subsidiary of Parent ("Euro Finance"). Again, the notional amount of this swap was equal to the principal amount of the credit linked note. Under this swap, Euro Finance paid the product of the notional amount and a fixed interest rate. In exchange for these payments, SPV paid the product of a floating rate and the same notional amount. Euro Finance entered into a mirror interest rate swap with Bank. All of the terms of the mirror interest rate swap were identical with the swap between Euro Finance and SPV except, under this last swap, Euro Finance received the fixed rate leg and paid the floating rate leg. Assuming that the plain vanilla preferred stock issued by SPV to Bank bore a fixed interest rate, the swaps among Bank, Euro Finance and SPV had the effect of converting this yield to a floating rate to Bank.

After the transaction had been running for some time (presumably about 5 years), Bank exercised its call option to buy the 80% of the SPV common stock that it did not own. The exercise of the call option corresponded with the delivery of the bonds under the prepaid forward contract between SPV and Subsidiary. Presumably, at this time, all of the swaps terminated as well.

Federal Income Tax Reporting on the Transaction

Although there was some ambiguity in the reporting of the transactions described above, the taxpayers appear to have reported the transactions as follows:

1. Subsidiary deducted the interest accrued on the credit linked note that it issued to SPV.
2. Subsidiary did not include any income attributable to the appreciation in its position under the forward contract. There is a suggestion that Subsidiary either sold its position under the forward contract shortly prior to settlement or, at settlement, the bonds that it received at that time. Upon whichever of these events occurred, Subsidiary claimed to recognize a capital gain that it sheltered with existing capital losses.
3. All of the swaps were treated as notional principal contracts and income and expense was accrued under the regulations applicable to such contracts.[9]

The author speculates that the use of the capital losses possessed by Subsidiary was at the heart of the transaction. Within the Parent consolidated federal income tax return, Subsidiary's interest deduction should have been matched by the interest income earned by SPV, making these items a wash. The recognition of the interest income by SPV would have generated earnings and profits within SPV, allowing SPV to treat distributions made on the preferred stock taxable as a dividend.[10] Bank claimed an 80% DRD on such dividends. Through the initial interest rate swap between Parent and Subsidiary, Parent effectively lent the cash in respect of the interest payments on the credit linked note to Subsidiary. When Subsidiary recognized the income (under the prepaid forward contract) necessary to repay this loan, Subsidiary was able to shelter this income from federal income tax through the use of its capital losses. Thus, if the transaction had worked as planned, it would have accomplished the Herculean task of generating a capital gain without any speculation on the price of an asset that would be treated as a capital asset in Subsidiary's hands.

As an aside here, it is the view of the author that the need for this type of planning appears to be patently unfair. To the author, it remains a mystery as to why corporate taxpayers should not be permitted to use capital losses to shelter ordinary income. For individuals, the reason is clear: long-term capital gains are tax-preferenced items and individuals should be required to "ring-fence" capital losses against capital gains. But given that there is no tax preference for capital gains recognized by corporations, there does not appear to a tax policy justification for the limitation on the use of capital losses by corporations.

[9] See Treas. Reg. § 1.446-3(c).

[10] See Code § 316(a).

The IRS Attack on the Tax Reporting for the Transactions

The IRS did not challenge the characterization of the prepaid forward contract between Subsidiary and Euro International as a forward contract for federal income tax purposes. The IRS further recognized that the bonds to be delivered to Subsidiary by Euro International would have a basis equal to the upfront payment made by Subsidiary and that, ordinarily, any gain recognized by Subsidiary on the disposition of either the forward contract or the bonds would be capital gain. Importantly, the IRS did not assert that there was an embedded time value of money element that should be taxed on a current or deferred basis to Subsidiary. The IRS did, however, find a basis to challenge the character of the gain recognized by Subsidiary as capital gain.

Application of the Straddle Rules. The IRS asserted that Subsidiary's positions under the prepaid forward contract and the credit linked note constituted a straddle within the meaning of Code § 1092(c). A straddle exists when a taxpayer holds offsetting positions in personal property, including debt instruments (such as the bonds to be delivered to Subsidiary under the forward contract). Under proposed Treasury Regulations, the IRS treats positions in debt instruments (such as the credit linked note issued by Subsidiary) as part of a straddle when one or more payments are linked to the value of personal property.[11] Since the credit linkage under the credit linked note and debt instruments to be delivered under the prepaid forward contract were "substantially similar," the IRS found that Subsidiary's positions under the credit linked note and the prepaid forward contract were offsetting positions with respect to the high grade bonds referenced in each position, even though there was not a complete overlap between the two reference portfolios.

TO THE AUTHOR, IT REMAINS A MYSTERY AS TO WHY CORPORATE TAXPAYERS SHOULD NOT BE PERMITTED TO USE CAPITAL LOSSES TO SHELTER ORDINARY INCOME. GIVEN THAT THERE IS NO TAX PREFERENCE FOR CAPITAL GAINS RECOGNIZED BY CORPORATIONS, THERE DOES NOT APPEAR TO A TAX POLICY JUSTIFICATION FOR THE LIMITATION ON THE USE OF CAPITAL LOSSES BY CORPORATIONS.

Interestingly, the IRS also asserted that a straddle existed between Subsidiary's position under the interest rate swap with Parent and the prepaid forward contract. Since Subsidiary prepaid its obligations under the forward contract, a fixed discount rate must have been used to determine the prepayment. Under the swap between Subsidiary and Parent, Subsidiary received floating rate payments. From these facts, the IRS found that if interest rates fell and the value of the position under the swap fell, Subsidiary would have a more valuable position under the forward contract. *Vice versa*, if interest rates rose and Subsidiary's position under the forward contract fell in value, its position under the interest rate swap would have increased in value. The fact that the IRS had already found a straddle involving the forward contract did not prevent the finding of a second straddle involving the same position.

When the straddle rules apply, a taxpayer is not entitled to deductions for interest and other carrying charges incurred on positions within a straddle to the extent that deductions exceed income from the property comprising the straddle.[12] Instead, these amounts are capitalized into the straddle positions. The IRS, under this rule, denied Subsidiary an interest deduction for the interest paid on the credit linked note and for accruals on the swap with Parent. The denial of the deductions to Subsidiary, however, should not have affected whether SPV had income or whether SPV had sufficient earnings and profits to support the treatment of distributions on the SPV preferred stock as dividends. This determination would have increased the income of the Parent group for each year of the transaction until the straddle was unwound in 2011.

Application of the Conversion Transaction Rules. Code § 1258(a) provides that gain from the disposition of a capital asset which is recognized on the disposition or termination of any position which is held as part of a "conversion transaction" can be treated in whole or in part as ordinary income. A conversion transaction is defined to include a transaction that satisfies two tests:

1. Substantially all of the taxpayer's expected return is attributable to the time value of the taxpayer's net investment in the transaction; and
2. It constitutes one of the following types of transactions:
   a. the holding of property and the entering into a substantially contemporaneous contract to sell property at a price determined in accordance with that contract;
   b. a straddle; or
   c. a transaction that is marketed or sold as producing capital gains from a transaction that meets the first test stated above.[13]

[11] Prop. Treas. Reg. § 1.1092(d)-1(d).

[12] Code § 263(g).

[13] Code § 1258(c). Conversion transactions include any other transaction identified by the IRS in regulations, but no such transactions have been designated by the IRS as such. Code § 1258(c)(2)(D).

The legislative history accompanying the enactment of Code § 1258 elaborates on the first requirement:

> In a conversion transaction, the taxpayer is in the economic position of a lender – he has an expectation of a return from the transaction which in substance is in the nature of interest and he undertakes no significant risks other than those typical of a lender.

A taxpayer's net investment in a conversion transaction "generally will be the aggregate amount invested by the taxpayer in the conversion transaction less any amount received by the taxpayer for entering into any position held as part of the conversion transaction." Accordingly, in order for any transaction to be treated as a conversion transaction, it must provide the taxpayer with a return that is akin to the yield that a lender would receive and not pose risks greater than those that a lender would normally bear.

The IRS held that the straddle relationship between the prepaid forward contract and the credit linked note caused the two positions to be considered a "conversion transaction" in Subsidiary's hands. The IRS held that Subsidiary did not earn its return from a speculative position in the portfolio of bonds referenced in the prepaid forward contract because any loss on the portfolio could be passed through to SPV under the credit linked note[14] and Subsidiary's return was "economically linked to the interest earned on those securities." Since the IRS found that a straddle existed and Subsidiary's return was attributable to the time value of money, the IRS held that the conversion transaction rules caused the gain on the settlement of the forward contract transaction to be ordinary income and not capital gain. Accordingly, the IRS sought to prevent Subsidiary from using its capital losses against the gain recognized on the forward contract settlement.

CHIEF COUNSEL ADVICE 201320014 (RELEASE DATE MAY 17, 2013)

In contrast to the bilateral transaction between unrelated parties encountered in FAA 20131701F, the IRS chose to challenge the availability of a DRD in a solely related party transaction in CCA 201320014. In an unusually erudite evaluation of an operational restructuring to obtain a DRD, the IRS found that a series of transactions admittedly undertaken for the purpose of converting interest income to dividend income eligible for the DRD would not be respected for federal income tax purposes. In this highly structured transaction, from the outset, the parties knew and intended that a U.S. shareholder of a controlled foreign corporation (a "CFC") would be required to dispose of stock in the corporation that paid the DRD eligible income prior to the last day of the CFC's taxable year in order to prevent the DRD eligible income from being recharacterized as subpart F income that would not carry out a DRD. The analysis contained in the CCA hinges on the fact that the parties knew and executed these transactions for the sole purpose of enhancing the after-tax return on the interest income from the federal income tax rechacterterization.

IN AN UNUSUALLY ERUDITE EVALUATION OF AN OPERATIONAL RESTRUCTURING TO OBTAIN A DRD, THE IRS FOUND THAT A SERIES OF TRANSACTIONS ADMITTEDLY UNDERTAKEN FOR THE PURPOSE OF CONVERTING INTEREST INCOME TO DIVIDEND INCOME ELIGIBLE FOR THE DRD WOULD NOT BE RESPECTED FOR FEDERAL INCOME TAX PURPOSES.

The taxpayer involved in the transactions described CCA 201320014 was a U.S. bulge-bracket investment bank. It received collateral deposits from clients and counterparties. The taxpayer was required to pay interest on such collateral deposits. The taxpayer was required to, and in fact did, invest the collateral deposits in high grade liquid assets. The taxpayer earned more interest on the investments than it was required to pay to its clients (such excess, the "Spread"). The taxpayer's internal documents stated that the impetus for the transactions described below was a desire to undertake a transaction that would decrease the amount of federal income tax that it earned on the Spread.

Transaction Steps

Simplified, the taxpayer undertook a nine step restructuring plan involving the following steps:

1. What appear to be different branches of a first tier subsidiary of the taxpayer (for example, the U.S. branch and the London branch) exchanged client collateral for cash collateral pursuant to a securities lending agreement.
2. The branch that received the cash collateral transferred the cash to the taxpayer.
3. The taxpayer transferred the cash to a CFC ("FSub-1") for common and preferred stock in FSub-1.
4. FSub-1 transferred the cash received from the taxpayer to a regulated investment company ("RIC") in exchange for RIC stock.
5. The RIC invested the cash received from FSub-1 in high grade liquid debt instruments.
6. Prior to the end of FSub-1's tax year, FSub-1 distributed the cash that it received from RIC (net of expenses) to the taxpayer.
7. FSub-1 then terminated its interest in the RIC and RIC liquidated.

[14] The IRS referred to the positions under the prepaid forward contract and the credit linked notes as "nearly identical."

8. Parent sold all of its FSub-1 stock to a domestic partnership.
9. FSub-1 liquidated.

The CCA does not make clear whether FSub-1 was newly-formed pursuant to the transactions described above. The Advice does state, however, that FSub-1 did not possess any dedicated employees. It does appear, however, that employees of other taxpayer affiliates were dual-hatted as FSub-1 employees. It further does not appear that FSub-1 was subject to any non-U.S. taxes on the income that it received from RIC.

Tax Reporting of the Nine Step Transaction

The RIC did not pay any federal income tax on the interest income and capital gains that it earned by claiming a dividend paid deduction. The dividend paid deduction is available only in limited circumstances to certain specified corporations, but was available to the RIC.[15] Even though FSub-1 was a CFC and the taxpayer would have had to include the income paid to FSub-1 as subpart F income and not as a dividend if taxpayer had held the FSub-1 stock at year end, taxpayer took the position that since it disposed of the stock of FSub-1 to another U.S. taxpayer prior to the end of FSub-1's tax year, the DRD rules applied.[16] Under applicable rules, even though FSub-1 was a non-U.S. corporation, dividends paid by FSub-1 were eligible for the DRD in full because 100% of the income of FSub-1 was derived from U.S. sources.[17]

We note that as a technical matter, the IRS did not dispute that this reporting was consistent with the literal provisions of the Code. The taxpayer defended its reporting position on the basis that the transactions were undertaken "to increase its return on the investment of the Customer Funds by the amount of the section 245 DRD." As more fully described below, the IRS refused to accept this business purpose as a valid non-tax business purpose.

> CODE § 246(C)(4) PROVIDES THAT FOR PURPOSES OF MAINTAINING THE REQUIRED HOLDING PERIOD FOR DRD ELIGIBILITY, A TAXPAYER'S HOLDING PERIOD WILL BE REDUCED FOR PERIODS WHEN "UNDER REGULATIONS PRESCRIBED BY THE SECRETARY, A TAXPAYER HAS DIMINISHED HIS RISK OF LOSS BY HOLDING ONE OR MORE OTHER POSITIONS WITH RESPECT TO SUBSTANTIALLY SIMILAR OR RELATED PROPERTY."

The IRS Challenges to the Taxpayer's Reporting of the Transactions

The IRS began its attack on the taxpayer's claim of a DRD with respect to the distributions that FSub-1 made to Parent with a discussion of the substance versus form doctrine. The IRS stated that the "routing of the investment and investment returns through FSub-1 and RIC did not serve a meaningful business purpose" and such steps were a "contrivance to avoid U.S. federal income tax." In support of this conclusion, the IRS noted that the taxpayer planned to terminate its direct ownership of FSub-1 prior to FSub-1's tax year for the purpose of avoiding a subpart F inclusion. The IRS further cited to the fact that the re-routing of the monies through the structure did not enable the taxpayer to enhance the pretax return on the investments. In fact, the "significant costs" of the transactions actually reduced the pretax return. The transactions also raised regulatory concerns. The taxpayer undertook a "liquidity test" in which the structure was unwound and reconstituted on the same day to ensure that the structure would not inhibit the taxpayer from accessing the client funds. The IRS cited to this fact that the transactions actually had a deleterious non-tax effect and that the only reason that the taxpayer implemented the transactions was to obtain a DRD. The IRS also discounted any benefit that the taxpayer could receive with respect to asset management, given the taxpayer's professed expertise in this area. Thus, in the view of the IRS the substance of the transaction did not comport with its form.

Next, the IRS directly considered whether the transactions should be considered to be within the intent of Congress in enacting and refining the DRD rules. The IRS cited legislative history almost 100 years old for the proposition that a DRD only applies "when 'the issuing corporation has already been taxed on the earnings' and the dividends remain in corporate solution." The IRS also analyzed the income earned by the RIC and found that the "RIC received no dividends that would qualify for a DRD if RIC were allowed a DRD, and therefore none of RIC's distributions were eligible for the DRD." This conclusion was reinforced by the fact that, under Code § 881(e), the RIC was not required to withhold U.S. federal income tax on distributions made to FSub-1 because the distributions retained their character as withholding tax-free interest even when distributed in the form of a RIC corporate dividend. The IRS acknowledged that the taxpayer would dispute these legislative purposes on the ground that the statute is clear on its face and does not impose a requirement that tax be imposed on the corporate earnings in order for a distribution to constitute a DRD eligible dividend.

To the author, the IRS found itself on its firmest footing for disallowing the DRD when it analyzed the subpart

15 See Code § 852(b)(2)(D).
16 See Code § 951(a).
17 Code § 245(a)(5)(B).

F aspects of the transactions. In this section of the CCA, the IRS concluded that the transactions should not be respected in the form in which they were undertaken. While the taxpayer correctly determined that there would not be a subpart F inclusion if it disposed of the FSub-1 stock prior to the end of the tax year of FSub-1, the IRS countered that this provision:

> [I]s not a tool for tax avoidance; rather, it is a necessary rule to prevent both the current and former shareholders from being subject to tax with respect to the same amount of the CFC's subpart F income.

A court could concur with the IRS on this point in light of the facts that taxpayer transferred the stock of FSub-1 to a related partnership in a transaction that was intended from the outset of the initial acquisition of the stock and was undertaken solely for the purpose of enabling the taxpayer to claim a DRD. The IRS's underlying point is that the subpart F inclusion rules were not intended to allow a former U.S. shareholder to achieve a better result by transferring its interest to a related party than holding the interest.

The IRS rounded out its challenges to the taxpayer's claim by asserting that it could apply the step transaction doctrine to challenge the availability of the DRD to the taxpayer. A full discussion of the step transaction doctrine is beyond the scope of this article. For our purposes, it suffices to note that the IRS found that the routing of funds through RIC and FSub-1 would have been "fruitless" without the completion of the subsequent steps, including the planned disposition of the FSub-1 stock prior to the year-end of FSub-1. The IRS found that the purpose of the transaction was not to create a RIC or transfer ownership of the assets, but to "have FSub-1 distribute RIC dividends to [the taxpayer] and to have [the taxpayer] dispose of its shares in FSub-1 just before the end of FSub-1's tax year." The liquidity test was viewed as evidence that Parent did not lose control of the funds even while they were held by RIC. Accordingly, the IRS found that insertion of FSub-1 and RIC into the transactions did not possess an independent business purpose. FSub-1 did not retain any profit on the transaction and its activities were directed by employee of the taxpayer. The combination of these factors led the IRS to assert that it could successfully challenge the involvement of RIC and FSub-1 in the transactions.

Lastly, the IRS made two additional attacks on the taxpayer's reporting of the transactions. First, the IRS asserted that the subpart F inclusion, not the DRD rules, should apply even though the taxpayer disposed of the stock of FSub-1 prior to the end of FSub-1's tax year. This argument was based on the fact that the taxpayer continued to possess the ability to control the stock following the disposition to the related partnership. Second, the IRS asserted that the use of the statutes in the manner in which they were used was contrary to the intent of the statutes. As a result, the taxpayer should not be entitled to directly plan into such results for a tax avoidance purpose.

FIELD ATTORNEY ADVICE 20131902F (RELEASE DATE MAY 10, 2013)

A corporate holder of stock is entitled to a DRD only if it meets certain holding period requirements with respect to the stock. Specifically, with respect to *common stock*, the shareholder must hold the stock for at least 46 days during the 91 day period beginning on the date that is 45 days before the ex-dividend date; and with respect to *preferred stock*, is at least 91 days during the 181 day period beginning on the date that is 90 days before the ex-dividend date.[18] Code § 246(c)(4) provides that for purposes of maintaining the required holding period for DRD eligibility, a taxpayer's holding period will be reduced for periods when "under regulations prescribed by the Secretary, a taxpayer has diminished his risk of loss by holding one or more other positions with respect to substantially similar or related property." Treasury Regulation § 1.246-5(c)(1)(ii) provides that when a taxpayer is holding more than 20 stocks and defeases risk through shorting an index (or a like transaction), the taxpayer's holding period for the stock will be suspended only if the two positions "substantially overlap." If the two positions do not substantially overlap, however, the Regulations also contain two anti-abuse rules, either of which will toll the taxpayer's holding period if they apply.

A CORPORATE HOLDER OF STOCK IS ENTITLED TO A DRD ONLY IF IT MEETS CERTAIN HOLDING PERIOD REQUIREMENTS WITH RESPECT TO THE STOCK.

Treasury Regulation § 1.246-5(c)(1)(vi) sets forth an anti-abuse rule pursuant to which, even if a taxpayer passes the "substantial overlap" rules of Treasury Regulation § 1.246-5(1)(ii), will toll the taxpayer's holding period if: (1) changes in the value of the position or the stocks reflected in the position are reasonably expected virtually to track (directly or inversely) changes in the value of the taxpayer's stock holdings, or any portion of such holdings and other positions of the taxpayer; and (2) the position is held or acquired as part of a plan a principal purpose of which is to obtain tax savings (including deferral) the value of which is significantly in excess of the expected pre-tax economic profits from the plan.[19] This anti-abuse rule addresses the potential avoidance of the sub-

[18] Code § 246(c)(1), (2).

[19] See T.D. 8590 (Mar. 20, 1995).

stantial overlap test by acquiring stock that is not formally reflected in a short index position, but that is comparable to, or highly correlated with, such stock. Thus, the taxpayer must hold a position in stock and also hold (or benefit from) a contra position, which would then be tested to determine if it offsets the taxpayer's long stock holdings. Furthermore, such contra position must "virtually" track the value of the stockholdings (a high threshold), and be acquired or held as part of a plan, a principal purpose of which is to obtain tax savings significantly in excess of the expected pre-tax economic profits from the plan.

Treasury Regulation § 1.246-5(c)(6) provides that positions held in related party or pass-through structures "with a view towards avoiding this section (the holding period requirement)" can be re-characterized as diminishing risk of loss. Specifically, the Regulation provides that:

> Positions held by a party related to the taxpayer within the meaning of sections 267(b) or 707(b)(1) are treated as positions held by the taxpayer if the positions are held with a view to avoiding the application of this section or § 1.1092(d)-2. In addition, a taxpayer is treated as diminishing its risk of loss by holding substantially similar or related property if the taxpayer holds an interest in, or is the beneficiary of, a pass-through entity, intermediary, or other arrangement with a view to avoiding the application of this section or § 1.1092(d)-2.

This anti-abuse rule addresses situations in which a taxpayer owns stock directly and also owns an interest in a related person or pass-through entity that holds offsetting short positions with respect to its long stock positions. Furthermore, this rule can also apply when the taxpayer owns an interest in an entity that holds stock, with respect to which the taxpayer has entered into an offsetting position in the hedge.

Proposed regulations contained an example for the related-party anti-abuse rule which was deleted in the final regulations for reasons that are not entirely clear. The deleted example offered the following guidance:

> On January 1, 1993, L Corporation purchased for $100,000 a basket of preferred stocks of companies in the utility industry. Also on January 1, 1993, L causes R Corporation, a wholly-owned subsidiary of L Corporation, to sell short $100,000 worth of utility index RFCs. Changes in the fair market value of the basket of preferred stocks are reasonably expected to approximate changes in the utility index. For purposes of section 246(c)(4)(C), the basket of preferred stocks of the utility companies held by L Corporation is substantially similar or related to the RFCs on the utility index held by its subsidiary, R Corporation. In addition, changes in the fair market values of the positions (the basket of preferred stocks and the short position in a RFC on the utility index) vary inversely. Thus, L Corporation is treated as having diminished its risk of loss on the basket of preferred stocks for purposes of section 246(c)(4)(C).[20]

In FAA 20131920F, a wholly-owned subsidiary of a common parent corporation ("X") included in a consolidated federal income tax return, held a portfolio of dividend-paying stocks. These stocks paid dividends and X, on its consolidated federal income tax return, claimed DRDs. During the years at issue, X entered into a series of put and call options on the S&P 500 index. X conceded that its purpose in entering into the option transactions was to "mitigate the risk of holding a portion of its equity portfolio." X also stated that "tax considerations were not sought, asked about or addressed in the establishment of the option program." X conceded that the options qualified as substantially similar or related property for purposes of the DRD rules. As a result, there is no discussion in the FAA as to the substantial overlap standard or the anti-abuse rules discussed above.

The sole issue addressed in the ruling was whether the DRD mandated holding period for the subsidiaries could be tolled by offsetting positions held by the corporate parent. The IRS cited to Treasury Regulation § 1.246-5(c)(6) for the proposition that positions held by related parties are treated as held by the corporate shareholder "if the positions are held with a view to avoiding the application of [the DRD rules]." The FAA then concludes that the risk mitigation purpose of the holding of the options is such a purpose and the holding period for the stock portfolio is tolled. As a result, the taxpayer was denied the DRD.

The concessions made by the taxpayer in FAA 20131920F make the issuance of the guidance somewhat curious.[21] The related party hedge issue addressed in the FAA is not a controversial one or one that seemingly needed much, if any, interpretation. The real issue seems to be whether the portfolio bore a relationship to the S&P500 options either under the mechanical 20 stock test or the anti-abuse rules. But these issues were conceded by the taxpayer for purposes of the Advice. One cannot help but wonder if the question asked by the Field Auditor was really the question at issue. ■

MARK LEEDS (mleeds@mayerbrown.com; (212) 506-2499) is a tax partner with the New York office of Mayer Brown and the editor-in-chief of Derivatives:' Financial Products Report. *Mark will be speaking on these developments at the Institute of International Bankers 2013 Annual Tax Seminar in New York on June 17, 2013.*

20 See, Prop. Treas. Reg. § 1.246-5(d), Ex. 8 (FI-22-92 (5/27/1993)).

21 At least one other commentator has observed that this FAA is a case of strange facts making strange law. See Anthony Tuths, letter to the Editor, Tax Notes Today (May 28, 2013).

ISDA MARCH 2013 DODD-FRANK PROTOCOL (A.K.A. DODD-FRANK PROTOCOL 2.0)

AZAM H. AZIZ, GEOFFREY B. GOLDMAN, DONNA M. PARISI AND JAMES LARSEN

THIS ARTICLE EXAMINES THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION'S RECENTLY PUBLISHED MARCH 2013 DODD-FRANK PROTOCOL.

On March 22, 2013, ISDA published the March 2013 Dodd-Frank Protocol[1] (the "Protocol" or "Protocol 2.0"), which is designed to facilitate compliance with certain CFTC rules relating to clearing, portfolio reconciliation and swap trading relationship documentation.[2] The current deadline for compliance with these rules is July 1, 2013 and failure to complete Protocol 2.0 or enter into a substantially similar bilateral amendment addressing these requirements by the Adherence Deadline will likely result in swap dealers becoming unable or unwilling to enter into new swaps.[3] This article provides an overview of the Protocol's structure and a summary of changes that the Protocol will make to existing agreements between Protocol participants.

The operative provisions of the Protocol are found in the four schedules that comprise the ISDA March 2013 DF Supplement:

- Schedule 1 provides definitions;
- Schedule 2 covers a variety of CFTC rules, including, among other things, confirmations, clearing, and the end-user clearing exception;
- Schedule 3 provides a set of agreements intended to address the documentation requirements of the CFTC's risk valuation and dispute resolution regulations;
- Schedule 4 provides a set of agreements intended to address the documentation requirements of the CFTC's portfolio reconciliation regulations.

All parties automatically agree to Schedules 1 and 2 of the Supplement after they exchange questionnaires. Schedule 3 is mandatory for swap dealers, major swap participants and financial entities and Schedule 4 is mandatory for "**CFTC Swap Entities,**" which is defined as registered swap dealers, major swap participants and persons that in good faith expect to shortly register as such.[4] All other parties have the option to agree to Schedules 3 and 4. When both parties have agreed to the same Schedules, then the relevant Schedules are deemed incorporated into the swap trading documentation between the parties. Schedules 3 and 4 will only be effective on July 1, 2013 unless the CFTC again delays the compliance date of the rules, in which case the later date will be the effective date. None of the Schedules will be effective unless one of the parties is a registered swap dealer or major swap participant. The parties can also use Protocol 2.0 to enter into a deemed 2002 ISDA Master Agreement.

WHY IS PROTOCOL 2.0 NECESSARY?

Protocol 2.0 addresses a number of CFTC rules that are briefly described below. The Protocol is generally an efficient, industry wide solution to bring trading documentation into compliance with these regulations, but it is not mandatory and market participants can elect to address these regulatory requirements with their swap dealers on a bilateral basis. As a practical matter, however, given the volume of documents that swap dealers will need to amend before the Adherence Deadline, it is not likely that market participants will have time to bilaterally renegotiate their trading documentation. Market participants also have the option to do nothing, but this will likely result in a disruption of new trading activity following the Adherence Deadline. Note that ISDA's August 2012 Dodd-Frank Protocol[5] ("**Protocol 1.0**") addresses an entirely separate set of CFTC rules and completing that protocol does not impact the requirement to complete Protocol 2.0. There will likely be additional protocols published to address additional CFTC and SEC rulemakings.

Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers

On August 27, 2012, the CFTC adopted final regulations setting forth requirements for swap confirmation, swap trading relationship documentation ("**STRD**") and portfolio reconciliation for swap dealers. The CFTC has indicated that non-US swap dealers may not be required to comply with the STRD

[1] The full text of the ISDA March 2013 DF Protocol Agreement, the ISDA March 2013 DF Supplement and the ISDA March 2013 DF Protocol Questionnaire, can be found at: http://www2.isda.org/dodd-frank-documentation-initiative/.

[2] CFTC, Final Rule, Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55904 (Sept. 11, 2012). CFTC, Final Rule, Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74284 (Dec. 13, 2012) and CFTC, Final Rule, End-user Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42559 (July 19, 2012). This publication will focus on the use of the Protocol by swap dealers, although major swap participants are subject to the same rules and can also use the Protocol.

[3] The list of registered swap dealers can be found at: http://www.nfa.futures.org/NFA-swaps-information/SD-MSP-registry.HTML.

[4] For further information regarding the terms "swap dealer" and "major swap participant" please refer to our publication on this topic, available at: http://www.shearman.com/swap-dealer-major-swap-participant-and-eligible-contract-participant-sec-and-cftc-adopt-entity-definition-rules-07-13-2012/.

[5] Despite sharing a similar format and adherence mechanic, Protocol 2.0 and Protocol 1.0 address entirely different sets of CFTC regulations and completing one will in no way satisfy the requirements of the other. Information on Protocol 1.0 can be found at: http://www2.isda.org/functional-areas/protocol-management/protocol/8.

rules when transacting swaps with non-US persons, but the applicability of these rules to transactions involving non-US persons is currently in a state of flux, pending the release of the CFTC's final cross-border guidance.[6]

Swap Confirmation Rules: The swap confirmation rules require swap dealers and major swap participants to execute confirmations of all swap transactions in which their counterparty is another swap dealer or major swap participant on the first business day following the execution date. For swap transactions with other types of counterparties, swap dealers and major swap participants must send an acknowledgement of the transaction on the first business day following the execution date, and would be required to have policies and procedures in place to confirm the swap transaction on the first business day following the execution date for financial entities, and on the second business day for all other counterparties.

Swap Trading Relationship Documentation Rules: The STRD rules require swap dealers and major swap participants to document all terms governing their trading relationship in writing, including terms related to credit support arrangements, swap valuation methodologies, and limitation of termination rights if a party becomes subject to a special resolution regime. Swap dealers and major swap participants are also required to document certain information related to clearing of their swaps and the qualifications of their counterparties to invoke the end-user clearing exception. Such information must be sufficient to provide the swap dealer or major swap participant with a reasonable basis to believe that its counterparty meets the statutory conditions required for an exception from a mandatory clearing requirement.

Portfolio Reconciliation Rules: Swap dealers and major swap participants are required to reconcile swap portfolios with other swap dealers or major swap participants with varying frequency, depending upon the size of the particular portfolio. Discrepancies in material terms identified as part of a portfolio reconciliation process must be resolved immediately and discrepancies in valuation must be resolved within one business day. For swap portfolios involving a counterparty that is not a swap dealer or major swap participant, swap dealers and major swap participants must establish written policies and procedures to perform portfolio reconciliation and to resolve any identified discrepancies in the material terms or valuation of swaps in a timely fashion.

ISDA March 2013 DF Protocol Master Agreement

The Protocol gives parties the option to elect to enter into a deemed 2002 ISDA Master Agreement to govern swaps (defined to include excluded FX swaps and forwards) that are not (i) governed by an existing master agreement or (ii) agreed by the parties to be cleared on a derivatives clearing organization. The deemed 2002 ISDA Master Agreement has certain predetermined elections made to its schedule. The ISDA will be governed by New York law, multiple payment transaction netting will be applicable for FX Transactions and Currency Option Transactions only, and if the parties have completed Protocol 1.0, then this agreement will be supplemented per the terms of that protocol.

Where no ISDA Master Agreement is currently in place, this deemed ISDA permits the parties to satisfy certain portions of the STRD rules. However, because ISDA Master Agreements tend to be highly customized and heavily negotiated, many market participants that do not currently have an ISDA Master Agreement in place may prefer to negotiate their own agreement rather than enter into the default ISDA March 2013 DF Protocol Master Agreement.

PROTOCOL 2.0 IS GENERALLY AN EFFICIENT, INDUSTRY WIDE SOLUTION TO BRING TRADING DOCUMENTATION INTO COMPLIANCE WITH THESE REGULATIONS, BUT IT IS NOT MANDATORY AND MARKET PARTICIPANTS CAN ELECT TO ADDRESS THESE REGULATORY REQUIREMENTS WITH THEIR SWAP DEALERS ON A BILATERAL BASIS.

Mandatory Clearing

On December 13, 2012, the Federal Register published the CFTC's first clearing determination for "plain vanilla" fixed for floating interest rate swaps, forward rate agreements and basis swaps in US dollars, Euro, Sterling or Yen, and CDX and iTraxx index credit default swaps. The CFTC is phasing in compliance with this clearing requirement by dividing market participants into three categories and requiring the most active market participants to begin clearing first. The three categories of market participants are "Category 1 Entities," "Category 2 Entities," and "Category 3 Entities". In combination with Protocol 1.0, Protocol 2.0 permits swap dealers to obtain the necessary representations about when their counterparties become subject to this mandatory clearing requirement.

Category 1 Entities include swap dealers, major swap participants and active funds, and these entities were required to begin clearing swaps with other Category 1 Entities on March 11,

[6] For further information regarding the CFTC's cross-border guidance please refer to our publication on this topic, available at: http://www.shearman.com/cftc-issues-final-exemptive-order-temporarily-limiting-cross-border-application-of-the-swaps-provisions-of-the-dodd-frank-act-12-28-2012/.

2013.[7] Category 2 Entities generally include other financial entities, other than certain employee benefit plans and separately managed accounts, and these entities will be required to begin clearing swaps with Category 1 Entities or Category 2 Entities on June 10, 2013.[8] Category 3 Entities (i.e., all other market participants) will have to begin clearing on September 9, 2013, unless they are able to take advantage of a clearing exception or exemption.[9]

End-User Clearing Exception

Commercial end-users have been granted an optional exception from the mandatory clearing and trading requirement when certain conditions are met. The exception is available if the end-user is not a financial entity, the swap is being used to hedge or mitigate commercial risk, and the end-user satisfies its reporting obligations to the CFTC, including how it generally meets its financial obligations for non-cleared swaps.[10] The Protocol allows swap dealers to obtain representations from end-users to confirm that the swap is not required to be cleared and to ensure that the reporting obligations are properly complied with.

PROTOCOL ARCHITECTURE

Protocol 2.0 is structurally identical to Protocol 1.0, so market participants that have already completed Protocol 1.0 will be familiar with the elements of the Protocol, which are:

- the ISDA March 2013 DF Protocol Agreement ("**Protocol Agreement**");
- the ISDA March 2013 DF Protocol Adherence Letter ("**Adherence Letter**");
- the ISDA March 2013 DF Protocol Questionnaire ("**Questionnaire**");[11] and
- the ISDA March 2013 DF Supplement ("**Supplement**").

Signing the Adherence Letter indicates a person's intention to complete the protocol process by exchanging Protocol Questionnaires with its counterparties that have also submitted signed Adherence Letters. The Supplement contains the substantive provisions of the Protocol and these provisions only become effective upon an exchange of Questionnaires between counterparties. Using the Questionnaire, the parties will elect which portions of the Supplement they intend to incorporate into their swap documentation (e.g. ISDA Master Agreement) ("**Protocol Covered Agreement**").

WHAT DOES PROTOCOL 2.0 DO?

March 2013 DF Supplement Information: Both parties represent that the information they provide in the Questionnaire is accurate and agree to promptly update such information if it changes or becomes misleading or false.

Swap Confirmation: Both parties agree that unless they have otherwise agreed in writing, confirmations can be created by both parties exchanging matching written trade terms. This provision does not override any confirmation method that the parties have agreed in writing elsewhere (e.g. Section 9 of an ISDA Master Agreement).

Mandatory Clearing: Instead of asking market participants to potentially remake the Category 1 and Category 2 representations that they were asked to make in Addendums 1 and 2 of Protocol 1.0,[12] Protocol 2.0 instead includes a set of deemed representations. For example, if a person enters into a trade subject to mandatory clearing during a period when only such swaps between two Category 1 Entities are required to be cleared, but does not provide clearing instructions or provide another explanation for why clearing is not required, then that person will be deemed to represent that it is not a Category 1 Entity. Similarly, if a person enters into a trade subject to mandatory clearing during a period when only such swaps between Category 1 or 2 Entities are required to be cleared, but does not provide clearing instructions or provide another explanation for why clearing is not required, then that person will be deemed to represent that it is neither a Category 1 nor a Category 2 Entity. These deemed representations shift the notification

PROTOCOL 2.0 IS STRUCTURALLY IDENTICAL TO PROTOCOL 1.0, SO MARKET PARTICIPANTS THAT HAVE ALREADY COMPLETED PROTOCOL 1.0 WILL BE FAMILIAR WITH THE ELEMENTS OF THE PROTOCOL.

7 An active fund is a "private fund," as defined in Section 202(a) of the Investment Advisers Act of 1940, that (i) is not a third-party subaccount and (ii) has executed 200 or more swaps per month on average over the 12 months preceding November 1, 2012.

8 Category 2 Entities include (i) a commodity pool as defined in Section 1a(10) of the CEA and CFTC Regulations thereunder, (ii) a "private fund," as defined in Section 202(a) of the Investment Advisers Act of 1940 other than an Active Fund, or (iii) a person predominately engaged in activities that are in the business of banking, or in activities that are "financial in nature," as defined in Section 4(k) of the Bank Holding Company Act of 1956, provided that, in each case, the entity is not a third-party subaccount.

9 There is an extended clearing timeline for iTraxx index credit default swaps. Category 1 Entities must begin clearing of such swaps by April 26, 2013, Category 2 Entities must begin clearing of such swaps by July 25, 2013 and Category 3 Entities must begin clearing of such swaps by October 23, 2013.

10 For further information regarding the End-User Exception please refer to our end-user handbook, available at: http://www.shearman.com/a-corporate-end-users-handbook-for-dodd-frank-title-vii-compliance-10-03-2012/.

11 While ISDA has published a version of the Questionnaire that can be completed and physically exchanged, most market participants will likely opt to use the ISDA Amend platform that Markit has created for exchanging and matching Questionnaires, available at http://www.markit.com/en/products/distribution/counterparty-manager/isda-amend.page.

12 Protocol 1.0 permits market participants to represent that they are swap dealers, major swap participants, or active funds (i.e. Category 1 Entities) or "Category 2 Entities."

burden, and potentially the regulatory liability, to non-swap dealers.[13]

In light of these deemed representations and to the extent they have not already done so, Protocol adherents will want to determine if they are a Category 1 or 2 Entity and alert their swap dealers if they meet either definition. These representations may have been provided using Protocol 1.0, but because these questions were only added to the questionnaire in Addenda to the original Protocol 1.0, early adherents may need to revisit Markit's ISDA Amend[14] and update their questionnaires. These deemed representations will not apply to persons not subject to the clearing requirement because of the end-user clearing exception or other CFTC guidance, including, but not limited to, the CFTC's final order granting temporary relief from clearing for non-US persons under certain conditions.[15]

THE OLA WAS CREATED BY THE DODD-FRANK ACT TO CREATE A MECHANISM FOR LIQUIDATING "FINANCIAL COMPANIES," WHICH INCLUDES ENTITIES SUCH AS BANK HOLDING COMPANIES AND SYSTEMICALLY IMPORTANT NONBANKS DESIGNATED BY THE FINANCIAL STABILITY OVERSIGHT COUNCIL.

End-User Clearing Exception: The end-user clearing exception exempts commercial end-users from the CFTC's mandatory clearing determinations so long as certain conditions are satisfied. One of the conditions is that the use of the end-user exception is reported to a swap data repository, which can be done either on a trade by trade basis or on an annual basis. The end-user can either make an annual report itself, or it can alert its swap counterparty that no such annual report has been made in the last 365 days prior to entering into the swap and then provide the swap dealer with all the information required to submit the report for that particular trade. End-users that give notice that they are not clearing in reliance on the end-user exception represent that they are eligible to use the exception and that they have submitted the annual notice itself, or alternatively that they have provided all of the information to a swap dealer. Swap dealers represent that information given to them on a trade by trade basis will be reported to a swap data repository.

The Questionnaire offers parties eligible to use the End-User Exception the ability to make a standing election to do so, unless it instructs the swap dealer to the contrary. Regardless of whether the standing election is made, the Protocol deems any party electing to use the End-User Exception to represent that they have satisfied their reporting requirement using an annual filing unless they have notified their swap dealer that this is not the case. The Questionnaire offers parties the ability to provide this notification. The Questionnaire asks parties that will not be making the annual filing to provide their swap dealers with the information necessary for the swap dealer to satisfy the reporting requirement on a trade by trade basis.

Orderly Liquidation Authority: If a counterparty is a financial company[16] then in a scenario where the company faces failure, there is a risk of the FDIC being appointed receiver under the Orderly Liquidation Authority ("**OLA**") created by the Dodd-Frank Act. If the company is put into OLA, notwithstanding any agreement between the parties, the FDIC, subject to certain conditions, may transfer the agreements to another party. In this case, termination netting and termination provisions triggered by the company entering an insolvency proceeding may not be enforceable. For example, "qualified financial contracts" ("**QFCs**") are subject to a one-day "stay" when the FDIC is appointed as receiver under the OLA. The OLA's approach to QFCs mirrors the approach to QFCs under the Federal Deposit Insurance Act with respect to the FDIC acting as receiver for an insured depository institution.[17] In order to monitor and assess the risk of a company entering OLA, both parties agree to alert the other party if there is any reason to believe that there is any change in their own status as a financial company that could be subject to OLA.

The OLA was created by the Dodd-Frank Act to create a mechanism for liquidating "financial companies," which includes entities such as bank holding companies and systemically important nonbanks designated by the Financial Stability Oversight Council (insured depository institutions are not covered by the OLA). The OLA is intended to solve the "too-big-to-fail" problem by ensuring that there is a mechanism to resolve a failing financial company without risking systemic consequences across the financial system and the broader economy. The FDIC, which would be the receiver of a financial company subject to the OLA, has been developing a strategy for a resolution under this new framework.

However, it is not clear that the FDIC's strategy would be viable if a large, complex financial institution faced failure today.

Risk Valuation and Dispute Resolution: Schedule 3 is mandatory for swap

[13] 17 C.F.R. pt. 50.25(a).

[14] Go to ISDA Amend at http://www.markit.com/en/products/distribution/document-exchange/registration.page and complete the Questionnaire and permission counterparties to receive the Questionnaire.

[15] For further information regarding this order please refer to our publication on this topic, available at: http://www.shearman.com/cftc-issues-final-exemptive-order-temporarily-limiting-cross-border-application-of-the-swaps-provisions-of-the-dodd-frank-act-12-28-2012/.

[16] 12 U.S.C. § 5381(a)(11).

[17] 12 U.S.C. § 1813.

dealers, major swap participants and financial entities. The risk valuation and dispute resolution provisions were intended to come into effect after the CFTC issued mandatory margin requirements for uncleared swaps, but the CFTC has not yet issued such requirements. Consequently, these provisions are exclusively for the purpose of allowing swap dealers to comply with the CFTC's risk management requirements. The Protocol goes to great lengths to clarify that no valuation procedure or dispute mechanism will replace or amend any such procedure or mechanism (including with respect to trade or collateral valuation) that the parties have otherwise agreed to.

Schedule 3 provide that the swap dealer will calculate the value of the swaps between the parties using the process agreed to in the credit support annex ("**CSA**"), if any, acting in good faith and using commercially reasonable procedures in order to produce a commercially reasonable result. If no CSA exists, then the swap dealer will calculate the amount payable as if the trades were being terminated in accordance with the close-out mechanics in their ISDA, and if no close-out mechanics were agreed, then the swaps will be valued in accordance with the 2002 ISDA Master Agreement's Close-out Amount method. The swaps will generally be valued at mid-market prices.

In contrast to a typical CSA, the swap dealer's counterparty has the option to perform its own calculation under the provisions of the CSA and deliver the calculations to the swap dealer, who can then use these calculations if it determines in good faith that the calculations satisfy the CFTC's requirements. Counterparties can request notification of the swap dealer's valuations.

A counterparty to a swap dealer will have one joint business day to dispute the valuations and must provide their own calculations, calculated in good faith and using commercially reasonable procedures in order to produce a commercially reasonable result. Any previously agreed CSA dispute mechanisms shall be used to resolve the dispute, but where no such dispute mechanisms exist, a default dispute resolution provision shall apply and will look to mid-market quotations obtained from market-makers.

MOST MARKET PARTICIPANTS WILL LIKELY FIND THE PROTOCOL TO BE THE SIMPLEST AND MOST EFFICIENT METHOD FOR BRINGING THEIR SWAP DOCUMENTATION INTO COMPLIANCE WITH THE CFTC'S STRD RULES AND OBTAINING THE NECESSARY REPRESENTATIONS RELATED TO MANDATORY CLEARING AND THE END-USER CLEARING EXCEPTION.

Financial Entity Ambiguity: Schedule 3 is mandatory for "financial entities" defined as a person that is a financial entity as defined in Section 2(h)(7)(C)(i) of the CEA,[18] without regard to the small bank exclusion[19] or the captive finance company limitation.[20] Protocol 2.0's expansion of the CEA's financial entity definition is potentially problematic for small banks and captive finance companies, because Protocol 2.0's financial entity representation is deemed an update to Protocol 1.0's financial entity representation, but does make any provision of the CFTC's different financial entity definitions. The CFTC considers small banks and captive finance companies to be financial entities for purposes of the CFTC's confirmation and STRD rules, but non-financial entities for purposes of the CFTC's clearing and swap data repository reporting rules. Protocol 2.0's financial entity definition generally tracks the definition used for the CFTC's confirmation and STRD rules.[21] Protocol 1.0's financial entity definition generally matches the definition used for the CFTC's clearing and swap data repository reporting rules.[22] Because Protocol 2.0's financial entity representation overrides Protocol 1.0's representation, if these entities follow Protocol 2.0's instructions, small banks and captive finance companies will represent that they are financial entities for purposes of swap data repository reporting. This may result in inaccurate swap data repository reporting and create significant confusion for small banks and captive finance companies completing the questionnaire.

Portfolio Reconciliation: Schedule 4 is mandatory for CFTC Swap Entities. If Schedule 4 is applicable, then swap dealers have the right to demand a portfolio reconciliation upon notice to the counterparty and at the intervals required by the CFTC rules. Portfolio

[18] Section 2(h)(7)(C)(i) of the CEA defines a "financial entity" for purposes of mandatory clearing as (i) a swap dealer, (ii) a security-based swap dealer, (iii) a major swap participant, (iv) a major security-based swap participant, (v) a commodity pool, (vi) a private fund as defined in Section 202(a) of the Investment Advisors Act of 1940, (vii) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974, and (viii) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956.

[19] CEA § 2(h)(7)(C)(ii) and 17 C.F.R. pt. 50.50(d).

[20] Protocol 2.0's definition of financial entity is: (i) a swap dealer, (ii) a security-based swap dealer, (iii) a major swap participant, (iv) a major security-based swap participant, (v) a commodity pool, (vi) a private fund as defined in Section 202(a) of the Investment Advisors Act of 1940, (vii) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974, and (viii) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956.

[21] 17 C.F.R. pt. 23.500(e).

[22] CEA § 2(h)(7)(C)(iii).

reconciliation can be accomplished in one of two ways. First, if both parties are CFTC Swap Entities or both parties have agreed to mutual exchange of portfolio data, then the parties will exchange and compare the material terms and valuations of the swaps between them. Second, if only one party is a CFTC Swap Entity and the parties have agreed to one-way delivery of portfolio data, then the swap dealer will deliver the data to the other party which will then review and compare the material terms and valuations of the swaps against its own books and records. In all cases, the parties agree to alert their counterparty of any discrepancy, except that if the valuation discrepancy is less than 10% of the larger of the two calculations, no notification obligation exists.

The parties can agree to reconcile the material terms of the swaps against the data from a swap data repository to the extent possible, but either party can unilaterally demand full portfolio reconciliation upon two joint business days' notice.

CONSEQUENCES OF A MISREPRESENTATION OR BREACH

The Protocol explicitly provides that a breach of any representation, covenant or agreement contained exclusively in the Protocol will not result in an event of default, termination event or other similar event that gives a party the right to terminate a swap. However, the Protocol is equally clear that if an identical representation, covenant or agreement is contained elsewhere in the Protocol Covered Agreement, then this limitation will not affect the parties' remedies under the Protocol Covered Agreement. Additionally, the Protocol is an agreement between the two adhering parties and a breach any of the Protocol's representations, warranties and covenants may give rise to common law remedies.

CONCLUSION

Most market participants will likely find the Protocol to be the simplest and most efficient method for bringing their swap documentation into compliance with the CFTC's STRD rules and obtaining the necessary representations related to mandatory clearing and the end-user clearing exception. As market participants begin to adhere, swap dealers will likely begin to form policies regarding certain issues, such as the election of Schedules 3 and 4. ■

AZAM H. AZIZ, GEOFFREY B. GOLDMAN and DONNA M. PARISI are partners, and JAMES LARSEN is an associate, in the New York office of Shearman & Sterling LLP.

THE EUROPEAN ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE—A NON-EU FUND MANAGER'S PERSPECTIVE

JEREMY C. JENNINGS-MARES, JAY G. BARIS AND AFIA FENING

THIS ARTICLE EXAMINES THE KEY OBLIGATIONS IMPOSED ON NON-EU AIFMS MANAGING OR MARKETING AIFS IN THE EU BY THE AIFM DIRECTIVE AND THE DELEGATED REGULATION SUPPLEMENTING THE AIFMD.

The European Member States must implement the Directive on Alternative Investment Fund Managers (the "AIFMD"),[1] which came into force on July 21, 2011, into their national laws by July 22, 2013. Once the Directive is fully implemented, non-EU AIFMDs that wish to offer interests in private placements will have new compliance and reporting responsibilities.

This article will discuss the key obligations imposed by the AIFM Directive and the delegated regulation supplementing the AIFMD (the "Regulation") on non-EU AIFMs managing or marketing AIFs in the EU.

The AIFMD is focused not only on fund managers ("AIFMs") based in Europe, but extends also to the management of European alternative investment funds ("AIFs") by non-EU AIFMs, as well as to AIFMs of EU and non-EU AIFs, wherever the manager is based, where those funds are being marketed within the EU.

On December 19, 2012, the European Commission also published the Regulation,[2] the purpose of which is to create a single EU rulebook for AIFMs by providing rules which will have automatic application across all the EU Member States. The Regulation contains rules which develop the principles established by the AIFM Directive in a number of key areas including:

- calculation of value of assets under management;
- calculation of leverage;
- professional indemnity insurance to be held by AIFMs;
- operational and conduct of business requirements for AIFMs, including rules on conflicts of interest, risk management, liquidity management, investment in securitization positions, internal governance and organizational requirements, valuation and delegation of AIFM functions;[3]
- obligations and rights of depositaries;
- transparency requirements as regards investors and supervisory authorities; and

[1] See the final adopted text at, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:01:EN:PDF.

[2] See Morrison & Foerster client alert: The New EU Directive on AIFM (17 November 2010), http://www.mofo.com/files/Uploads/Images/101117-New-EU-Directive-on-AIFMs.pdf.

[3] See the final adopted text at, ec.europa.eu/internal_market/investment/docs/20121219-directive/delegated-act_en.pdf.

- cooperation arrangements with third countries.

The Regulation entered into force on April 11, 2013 and is to be effective from July 22, 2013.

What is an AIF?

The concept of an AIF is very broad-reaching, and is defined as a collective investment undertaking (including investment compartments thereof) which are not UCITs funds, but which raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors. However, from that broad general definition, it expressly excludes entities and arrangements, such as segregated managed accounts, family offices, joint ventures, insurance contracts, certain special purpose vehicles and employee participation or savings schemes.

"AIFM" is defined very simply as meaning a legal person whose regular business is the managing of one or more AIFs.

It should be noted that there is no requirement for a fund or a manager to be established or based in the European Union in order to fall within these definitions.

However, an AIFM will not be caught by the majority of the provisions of the AIFMD if the aggregate assets of all AIFs under its management do not exceed EUR 500 million (in respect of unleveraged AIFs where investors cannot redeem within 5 years) or EUR 100 million (in respect of leveraged AIFs). Such AIFMs have only basic obligations in relation to registration and notification of certain information. However, they will not be able to take advantage of the EU passporting benefits under the AIFMD unless they decided to opt-in fully to the AIFMD's requirements.

What does "Managing an AIF" mean?

Managing an AIF involves performing portfolio management activities and/or risk management activities for an AIF.

Each AIF which is within the scope of the AIFMD must have a single AIFM, for the purposes of the AIFMD, although it can continue to utilize the services of multiple entities, in terms of management and administration activities. Therefore, if there are various entities which perform activities on behalf of an AIF that will fall within the scope of the AIFMD, it will be necessary to position one of those entities to perform the job of the AIFM and become authorized under the Directive. In order to structure the positioning of such an entity to be an AIFM, care must be taken to ensure that any delegation of responsibilities by that AIFM is not so extensive as to render that entity a letter-box entity, pursuant to the detailed rules in the AIFMD in this regard. A letter-box entity will not qualify to be the AIFM for an AIF. Note in this regard that the delegation of all management and administration functions must be compared against the AIFMD requirements—not just the portfolio management and risk management functions.

What are the restrictions on managing EU AIFs?

An EU AIF is defined as one which is either authorized or registered in an EU Member State, or which has its registered office and/or head office in an EU Member State. A non-EU AIFM, *i.e.* an AIFM which does not have its registered office in an EU Member State, which intends to manage an EU AIF must acquire prior authorization by the competent authorities of their Member State of reference. In this regard, the Member State of reference will vary depending upon such factors as whether one or more than one AIF is being managed and, if the latter, whether the AIFs have different home Member States, as well as whether the AIFM is or is not intending to market one or more of the AIFs within the EU under the passport mechanism provided for by the Directive.

THE AIFMD IS FOCUSED NOT ONLY ON FUND MANAGERS BASED IN EUROPE, BUT EXTENDS ALSO TO THE MANAGEMENT OF EUROPEAN ALTERNATIVE INVESTMENT FUNDS BY NON-EU AIFMS, AS WELL AS TO AIFMS OF EU AND NON-EU AIFS, WHEREVER THE MANAGER IS BASED, WHERE THOSE FUNDS ARE BEING MARKETED WITHIN THE EU.

In what circumstances is an AIFM permitted to market an AIF within the EU?

A non-EU AIFM which intends to market an AIF (whether an EU AIF or a non-EU AIF) within the EU pursuant to the passport mechanism provided for by the Directive (which is expected to become available from 2015), will at that point require authorization by the competent authorities of the AIFM's Member State of reference. Determining the Member State of reference in these circumstances is complex and depends on factors such as how many AIFs are being marketed and in how many different Member States, as well as whether the AIF itself is or is not authorized or registered in a Member State. The Directive acknowledges that in certain cases it is possible for an AIFM to have more than one Member State of reference and in such cases, the AIFM must submit a request to the competent authorities of all the possible Member States of reference in order for them to jointly decide which will be the one Member State of reference.

"Marketing" in this context means a direct or indirect offering or placement, at the initiative of the non-EU

AIFM or on behalf of the non-EU AIFM, of units or shares of an AIF that it manages to or with investors domiciled or with a registered office in the EU.

AS THE AIFMD EXPLICITLY STATES THAT MARKETING IS ONLY CAUGHT IF MARKETING IS PERFORMED AT THE INITIATIVE OF THE NON-EU AIFM OR ON BEHALF OF THE NON-EU AIFM, THE AIFMD WILL NOT APPLY WHERE ANY INVESTOR IN THE EU APPROACHES A NON-EU AIFM, I.E. A REVERSE SOLICITATION.

As the AIFMD explicitly states that marketing is only caught if marketing is performed at the initiative of the non-EU AIFM or on behalf of the non-EU AIFM, the AIFMD will not apply where any investor in the EU approaches a non-EU AIFM, *i.e.* a reverse solicitation. This means that a professional investor will be able to continue to invest in an AIF by approaching the non-EU AIFM provided that the non-EU AIFM has not solicited the investor prior to the approach. The AIFMD does not contain much guidance on precisely when a professional investor may have made a reverse solicitation, and therefore non-EU AIFMs will need to approach the question of reverse solicitation with extreme caution.

When will the restrictions on marketing AIFs in the EU become effective?

Currently a non-EU AIFM may, in many EU Member States, market an AIF to professional investors using the national private placement regime in the relevant EU Member State.

From July 22, 2013 (*i.e.* the deadline for transposition of the AIFMD into the domestic law of each of the EU Member States), a non-EU AIFM that markets an AIF in the EU may continue to make use of any national private placement regimes in EU Member States, provided that certain minimum conditions are satisfied as follows:

- compliance with the obligations of an AIFM under Articles 22 to 24 of AIFMD, regarding submission and publication of an annual report for each AIF managed/marketed by it, the disclosure to investors, pre-investment, of key information relating to each AIF and regular reporting of key information to the competent authorities of each Member State in which it markets AIFs;
- cooperation arrangements and information exchange agreements must be in place between (a) the competent authorities of each EU Member State where the AIF is to be marketed; (b) the competent authority/supervisory authority of the member state/third country domicile of the AIF; and (c) the supervisory authority of the country where the non-EU AIFM is established. This is to ensure that information on the AIF and its non-EU AIFM can be exchanged efficiently to allow the competent authorities of the relevant EU Member States to carry out their supervisory duties effectively under the Directive; and
- at the time of marketing, neither the AIF nor the AIFM is authorized or registered in a country which is listed as a "Non-cooperative Country and Territory" by the Financial Action Task Force on anti-money laundering and terrorist financing ("FATF").

In relation to the UK's national private placement scheme, the UK Treasury has recently confirmed that any non-EU AIFM which is already marketing an AIF in the UK as at July 22, 2013, may continue to market the AIF in the UK up until July 22, 2014, without the need to comply with the above minimum conditions. Thereafter, though, it will need to be in full compliance in order to carry on its UK marketing activities.

The European Security and Markets Authority ("ESMA") is required to report to the European Commission by July 2015 on the functioning of national private placement regimes, and the possible extension of the AIFMD's passport regime to non-EU AIFMs. By 2018, ESMA must report on whether national private placement regimes should be abolished, and if they are abolished by the European Commission, then from 2018, a non-EU AIFM may only market AIFs to EU investors if it obtains an AIFMD "passport" with respect to its marketing activities. With a passport, a non-EU AIFM will enjoy the same access as an EU AIFM provided that it complies fully with the AIFMD.[4]

If any of the minimum conditions for utilizing existing national private placement regimes is not satisfied by the non-EU AIFM by the date of national transposition of the AIFMD, then (except as noted above in respect of the UK) a non-EU AIFM cannot thereafter continue to market an AIF to EU professional investors. Further, non-EU AIFMs who want to market their AIFs in the EU pursuant to an existing private placement regime will have to monitor whether the necessary co-operation arrangements between the relevant EU and non-EU competent authorities are put in place by July 22, 2013. Finally, EU Member States may impose rules on any AIFM (EU or non-EU) that are stricter than those in the Directive, in respect of the mar-

4 For more details of the contents of the AIFMD please see Morrison & Foerster client alert: The New EU Directive on AIFM (17 November 2010), www.mofo.com/files/Uploads/Images/101117-New-EU-Directive-on-AIFMs.pdf.

keting of non-EU AIFs to investors in their territory.

THE REGULATION

Annual Reports of non-EU AIFs

Under Article 22 of the AIFM Directive, non-EU AIFMs must provide to investors an audited annual report on the non-EU AIF.

The Regulation establishes criteria for the presentation of the non-EU AIF's balance sheet or statement of assets and liabilities and of the income and expenditure account.[5]

The Regulation further sets out in more detail the content of the remuneration disclosure required within the annual report (*i.e.* the total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the AIFM to its staff, the number of beneficiaries and (where relevant) carried interest paid by the AIF[6]). The AIFM is required to specify whether or not the total remuneration relates to any of the following:

- the total remuneration of the entire staff of the non-EU AIFM, indicating the number of beneficiaries;
- the total remuneration of those staff of the non-EU AIFM who are fully or partially involved in the activities of the non-EU AIF, indicating the number of beneficiaries;
- the proportion of the total remuneration of the staff of the non-EU AIFM attributable to the non-EU AIF, indicating the number of beneficiaries.

In addition, non-EU AIFMs must disclose general information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff to enable investors to assess the incentives created and to understand the risk profile of the non-EU AIF and the measures adopted to avoid or manage conflicts of interest.[7]

The above is in addition to the disclosure required in the annual report as to the remuneration paid to senior management and other staff whose actions have a material impact on the risk profile of the AIF.[8]

Disclosure to Investors in non-EU AIFs

Under Article 23 of the AIFM Directive, non-EU AIFMs must disclose key information regarding each AIF, including periodic disclosure of the percentage of the AIF's assets that are subject to special arrangements because they are illiquid, any new liquidity management arrangements and regular disclosures of the level of the AIF's leverage.

With respect to illiquid assets the Regulation now provides that non-EU AIFMs must disclose: (i) an overview of any special arrangements in place including whether they relate to side pockets, gates or other similar arrangements; (ii) the valuation methodology applied to assets which are subject to such arrangements; and (iii) how management and performance fees apply to these assets.

In the case of any new arrangements for managing the AIF's liquidity, AIFMs must notify investors of any material changes to management systems and procedures, as well as of activated gates, side pockets or similar special arrangements or where they decide to suspend redemptions.[9]

Further AIFMs must disclose the risk profile of the AIF and the main features of the risk management systems employed to manage the risk exposure of the AIF.[10]

With respect to leverage, AIFMs must disclose to investors information on changes to the maximum level of leverage calculated in accordance with the gross and commitment methods of calculating the AIF's exposure (as provided in Articles 7 and 8 of the Regulation), and any right of re-use of collateral or any guarantee under the leveraging arrangements.[11]

Reporting to Competent Authorities of Member State of Reference

Article 24 of the AIFM Directive provides that a non-EU AIFM will be required to report to the competent authority in each EU Member state where an AIF is marketed by it or on its behalf, information regarding the main markets in which it trades, regarding the financial instruments it trades, and the principal exposures and concentrations of all the AIFs managed by the non-EU AIFM.

> UNDER ARTICLE 23 OF THE AIFM DIRECTIVE, NON-EU AIFMS MUST DISCLOSE KEY INFORMATION REGARDING EACH AIF, INCLUDING PERIODIC DISCLOSURE OF THE PERCENTAGE OF THE AIF'S ASSETS THAT ARE SUBJECT TO SPECIAL ARRANGEMENTS BECAUSE THEY ARE ILLIQUID, ANY NEW LIQUIDITY MANAGEMENT ARRANGEMENTS AND REGULAR DISCLOSURES OF THE LEVEL OF THE AIF'S LEVERAGE.

The Regulation clarifies that in each country in which marketing takes place each non-EU AIFM will be required to provide the following information when reporting to the competent authorities:

- the main instruments in which it is trading, including a break-down of financial instruments and

5 Article 104-106 of the Regulation.
6 Article 22(2)(e) of the AIFMD.
7 Article 107 of the Regulation.
8 Article 22(2)(e) of the AIFMD.
9 Article 108 of the Regulation.
10 Article 23(4)(c) of the AIFMD.
11 Article 109 of the Regulation.

other assets, including the AIF's investment strategies and its geographical and sectoral investment focus;
- the markets of which it is a member or where it actively trades;
- the diversification of the non-EU AIF's portfolio, including, but not limited to, its principal exposures and key concentrations;

TO ALLOW NON-EU AIFMS TO MARKET AIFS IN THE EU, THE AIFMD REQUIRES THE APPROPRIATE COOPERATION ARRANGEMENTS TO BE IN PLACE WITH THE RELEVANT SUPERVISORY AUTHORITIES OF THE THIRD COUNTRY IN WHICH THE AIF IS ESTABLISHED, THOSE OF THE COUNTRY IN WHICH THE AIFM IS ESTABLISHED AND THOSE OF THE EU MEMBER STATES IN WHICH THE AIF IS TO BE MARKETED.

- the percentage of the non-EU AIF's assets which are subject to special arrangements;
- any new arrangements for managing the liquidity of the non-EU AIF;
- the risk management systems employed by the non-EU AIFM to manage the market risk, liquidity risk, counterparty risk and other risks including operational risk; and
- the current risk profile of the non-EU AIF.

Reporting frequency by non-EU AIFMs is stated by the Regulation to be as follows:

- on a half-yearly basis for a non-EU AIFM with aggregate assets under management of up to EUR 1 billion (such reporting required in respect of each AIF it markets in the EU);
- on a quarterly basis for a non-EU AIFM with assets under management above EUR 1 billion (such reporting required in respect of each AIF it markets in the EU);
- on a quarterly basis in relation to any AIF whose assets under management, including any assets acquired through use of leverage, exceed EUR 500 million; and
- on an annual basis in respect of each unleveraged AIF, under the management of a non-EU AIFM, which invests in non-listed companies and issuers in order to acquire control.

Notably Articles 6, 7 and 8 of the Regulation provide further clarity on what is meant by leverage and the basis on which firms must calculate leverage. This is of importance to non-EU AIFMs marketing AIFs in Europe because specific reporting requirements to the competent authorities of the Member State of reference are triggered when an AIF employs leverage on a substantial basis. Under the Regulation, as AIF is considered to employ leverage on a substantial basis when its exposure is over three times its net asset value.[12]

Co-operation arrangements

To allow non-EU AIFMs to market AIFs in the EU, the AIFMD requires the appropriate cooperation arrangements to be in place with the relevant supervisory authorities of the third country in which the AIF is established, those of the country in which the AIFM is established and those of the EU Member States in which the AIF is to be marketed.

The Regulation provides that cooperation arrangements shall be in writing and sets out the scope, form and objectives of the cooperation arrangements. The Regulation also requires cooperation arrangements to provide for such mechanisms, instruments and procedures as are necessary for the EU competent authorities to perform their duties pursuant to the AIFMD. Further the Regulation requires cooperation arrangements to include a data protection safeguard in line with Article 52 of the AIFM Directive.[13]

Plan of Action for non-EU AIFMs marketing AIFs in the EU

In summary, a non-EU AIFM may currently market an AIF to EU professional investors under a Member State's private placement regime (*i.e.* as they can currently), so long as the individual Member State retains its regime. From the date of transposition of the Directive (i.e. no later than July 22, 2013) a non-EU AIFM can continue to use any Member State's private placement regime so long as it complies with the requirements in Articles 22 to 24 of the AIFM (as supplemented by the Regulation. In addition, a non-EU AIFM marketing an AIF in the UK as of such date may continue to do so for one year thereafter without complying with such requirements.

Non-EU AIFMs need to immediately begin to prepare for the implementation of the AIFM Directive in July 2013 as follows:

- consider all fund management activities in Europe to identify who might constitute an AIFM—for both sponsored and non-sponsored funds
- consider restructuring management activities/locations, if necessary;
- review all delegation arrangements in respect of management functions and benchmark against AIFMD requirements;
- identify all non-EU entities that perform delegated functions and

[12] Article 111 of the Regulation.

[13] Article 113-115 of the Regulation.

identify progress of co-operation agreements;
- consider restructuring delegation of one or more functions, if necessary;
- determine the "Member State of Reference" i.e. the appropriate competent authority for compliance with the AIFM;
- prepare for and ensure compliance with transparency and disclosure obligations required by the AIFM and the Regulation with respect to investors and competent authorities of the Member State of reference in respect of each AIF that it intends to market in the EU;
- check that neither the EU country where the non-EU AIFM is established, nor the country where the AIF is established, is not listed as a Non-Cooperative Country and Territory by FATF;
- monitor private placement regimes in key distribution territories to anticipate and plan for any changes;
- consider full compliance with the AIFM to gain access to an EU passport after 2015; and consider further changes required to structure of AIF if access of non-EU AIFMs to national private placement regimes is terminated with effect from 2018. ■

JEREMY C. JENNINGS-MARES is a partner and AFIA FENING is an associate in the London office of Morrison & Foerster (UK) LLP, and JAY G. BARIS is a partner in the firm's New York office.

CFTC STAFF PROVIDES INFORMAL RELIEF FOR SECURITIZATION VEHICLES FROM COMPLIANCE WITH NEW SWAP CLEARING RULES

RICHARD L. FRIED

THIS ARTICLE DESCRIBES INFORMAL RELIEF FOR SECURITIZATION VEHICLES FROM THE NEW SWAP CLEARING REQUIREMENTS.

The Commodity Futures Trading Commission (the "CFTC") staff recently advised the American Securitization Forum ("ASF") that securitization vehicles entering into interest rate swaps containing terms standard in the industry will not have to comply with the new swap clearing provisions of the Commodity Exchange Act (the "CEA"). The CFTC staff gave this advice orally and stated that it will not provide a written response before June 10, 2013, the date when securitization vehicles would be required to begin complying with the swap clearing provisions. It is unknown if the CFTC staff will provide a written response or other formal interpretation after that date.

Although the industry welcomed these developments, the lack of a written response from the CFTC staff, coupled with ambiguous language in the release accompanying the final swap clearing provisions (the "Release"),[1] creates uncertainty in this area.

This article examines the background to the new swap clearing provisions, the role of a clearing organization, the swaps to be cleared under the swap clearing provisions, the effective dates, by entity type, for compliance with the clearing requirements, and other product specifications.

TITLE VII OF THE DODD-FRANK ACT ESTABLISHED A NEW REGULATORY FRAMEWORK FOR SWAPS. CENTRAL TO THESE REGULATIONS IS THE REQUIREMENT THAT ALL SWAPS DETERMINED BY THE CFTC TO BE SUBJECT TO MANDATORY CLEARING MUST BE CLEARED BY A DERIVATIVES CLEARING ORGANIZATION.

BACKGROUND

In 2007 and 2008, as more and more banks and financial institutions reported more and more losses, filed for bankruptcy, or were seized by regulators, those remaining began circling the wagons and were reluctant to extend credit to even what had been the most credit-worthy entities. Markets became illiquid and the economy threatened to grind to a halt. Emergency programs implemented by the Bush Administration, and later the Obama Administration, helped restore a measure of order to the U.S. credit markets.

Against this backdrop, Congress passed, and President Obama signed into law, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Title VII of the Dodd-Frank Act established a new regulatory framework for swaps. Central to these regulations is the requirement that all swaps determined by the CFTC to be subject to mandatory clearing must be cleared by a derivatives clearing organization (a "DCO"). According to the Senate Report:

> As a key element of reducing systemic risk and protecting taxpayers in the future, protections must include comprehensive regulation and rules for how the OTC derivatives market operates. Increasing the use of central clearinghouses, exchanges, appropriate margining, capital requirements, and reporting will provide safeguards for American taxpayers and the financial system as a whole.[2]

ROLE OF A CLEARING ORGANIZATION

In a traditional over-the-counter swap, the two parties to the trade document

[1] 77 Fed. Reg. 74284 (December 13, 2012).

[2] *See* 77 Fed. Reg. 74285, footnote 14.

their transaction by entering into an International Swaps and Derivatives Association ("ISDA") Master Agreement, along with a related schedule and confirmation. These documents detail the terms of the swap and set any margin requirement agreed to by the parties. Each party relies solely on the credit of its counterparty (and any guarantor) and the terms of the transaction are not reported to any central exchange.

In contrast, if a swap is cleared with a DCO, the original contract between the parties is terminated and replaced by separate contracts between the DCO and each party. These new contracts contain the same economic terms as the original trade and are governed by the standard terms of the applicable DCO. The DCO becomes the new counterparty for both sides of the trade, and the credit of the DCO is substituted for the credit of the original parties. The DCO collects any required initial and variation margin from the two counterparties.

SWAPS REQUIRED TO BE CLEARED

On December 13, 2012, the CFTC made its first mandatory clearing determination by adopting regulations requiring two classes of credit default swaps ("CDS") and four classes of interest rate swaps that contain certain product specifications to be cleared by a DCO, **if** an eligible DCO clears the swap.

Determining if the clearing requirement applies to a particular swap is a two-step process. First, you must determine if the swap falls within one of the covered classes and, if so, whether any of the eligible DCOs clear that swap. Currently, there are four eligible DCOs for CDS and interest rate swaps.[3] The second step requires one to determine if all the product specifications required under the DCO's rules are met. If no eligible DCO accepts the swap for clearing because there is a different product specification, then the swap is not required to be cleared. In the Release, the CFTC stated that "market participants need not submit swaps to a DCO if they know that the DCO does not clear that particular swap."[4]

All persons executing a swap that is required to be cleared, must submit the swap to an eligible DCO that accepts such swap for clearing as soon as technologically practicable after execution, but in any event by the end of the day of execution. Each DCO must make publicly available on its web site a list of all swaps that it will accept for clearing and identify which swaps on the list are required to be cleared. The CFTC maintains a current list of all swaps that are required to be cleared and all DCOs that are eligible to clear such swaps.[5]

The two classes of CDS required to be cleared by a DCO are:

- Untranched CDS indices referencing North American corporate entities
- Untranched CDS indices referencing European corporate entities

The four classes of interest rate swaps required to be cleared by a DCO are:

- Fixed-to-floating swaps
- Basis swaps
- Forward rate agreements
- Overnight index swaps

According to the CFTC, the covered classes of CDS and interest rate swaps already were being cleared by a DCO and constitute the highest market share of all swaps. The CFTC intends subsequently to consider if other classes of swaps should be subject to the clearing requirement.

The CFTC listed in the Release the following three affirmative and three negative product specifications for each class of covered interest rate swaps:

Affirmative Specifications

- Currency in which the notional and payment amounts are specified
- Interest rates referenced for each leg of the swap
- Stated termination date

ON DECEMBER 13, 2012, THE CFTC MADE ITS FIRST MANDATORY CLEARING DETERMINATION BY ADOPTING REGULATIONS REQUIRING TWO CLASSES OF CREDIT DEFAULT SWAPS AND FOUR CLASSES OF INTEREST RATE SWAPS THAT CONTAIN CERTAIN PRODUCT SPECIFICATIONS TO BE CLEARED BY A DCO, IF AN ELIGIBLE DCO CLEARS THE SWAP.

Negative Specifications

- No optionality (as defined by the DCOs)
- No dual currencies
- No conditional notional amounts[6]

If an interest rate swap is in a specified class and satisfies the six specifications, the swap is subject to the clearing requirement if a DCO clears the particular swap. If an interest rate swap does not satisfy one or more of these specifications, it is not subject to the clearing requirement. Therefore, for example, swaps payable in different currencies (*i.e.*, one party is paid in U.S. Dollars and the other party is paid in Euros) are not required to be cleared because they do not satisfy the "no dual currencies" negative specification.

[3] The four eligible DCOs are CME Group, ICE Clear Credit, ICE Clear Europe, and LCH Clearnet Limited.

[4] 77 Fed. Reg. 74288.

[5] *See* http://sirt.cftc.gov/sirt/sirt.aspx?Topic=ClearingOrganizationProducts.

[6] "Conditional Notional Amount" refers to notional amounts that can change over the term of a swap based on a condition established by the parties upon execution such that the notional amount is not a known number or schedule of numbers, but may change based on the occurrence of some future event.

EFFECTIVE DATES

The effective date for when swap participants must comply with the clearing requirements varies by entity type. Swap dealers, major swap participants and "active" funds (private funds executing 200 or more swaps per month) were required to comply by March 11, 2013. Funds (other than active funds), commodity pools and "financial entities" (entities predominantly engaged in banking or activities that are financial in nature) must comply by June 10, 2013. All other entities must comply by September 9, 2013. The CFTC specified that swap participants need only clear swaps entered into on and after the applicable effective date.

Although there is no definitive authority directly on point, the market view is that securitization vehicles are "financial entities" under these rules and, absent an exemption or other relief, must begin complying on June 10, 2013.

OTHER PRODUCT SPECIFICATIONS

The CFTC stated in the Release that it also considered whether to define classes of swaps on the basis of other product specifications, which could be broken down into two general categories: (i) specifications commonly used to address mechanical issues for most swaps (*i.e.*, day count fractions) and (ii) specifications that are less common and address idiosyncratic issues related to the particular needs of a counterparty (*i.e.*, special representations, unique termination events and special fees).

Regarding the mechanical issues, the CFTC stated that the DCOs can provide clearing for the standard alternatives of each of these specifications without effecting risk management. As for the idiosyncratic terms, the CFTC stated that none of the DCOs clear interest rate swaps with those terms. Accordingly, "such specifications are not included in the classes of swaps subject to the clearing requirement proposed by this rule, and the [CFTC] considered only the first group of more common specifications that are identified by the submitting DCOs in their product specifications."

The CFTC went on to state:

> In short, the [CFTC] recognizes that these other specifications may have an effect on the economic result to be achieved with the swap. However, counterparties and DCOs may account for the effects of such specifications with adjustments to other specifications or in the price of the swap … Accordingly, the [CFTC] has determined not to include other, non-class defining specifications in the swap class definition.[7]

IDIOSYNCRATIC SPECIFICATIONS OF SECURITIZATION SWAPS

Regardless of asset type, securitization transactions involve the issuance of securities by a special purpose, bankruptcy remote entity ("SPV"). Payments on these securities are made from collections received on a designated pool of assets (or in certain transactions – notably auto lease transactions – from proceeds realized on the sale of assets) transferred to and owned by the SPV. Transaction documents, including swaps, entered into by the SPV contain provisions designed to help ensure the SPV's bankruptcy remoteness. Among these are "limited recourse" and "non-petition" provisions. In the limited recourse provision, creditors of the SPV (including swap counterparties) agree to look only to the assets owned by the SPV for payment of amounts owed to the creditor. In the non-petition provision, creditors agree that they will not file a bankruptcy petition against the SPV, or join in any such filing by another party.

Currently, DCOs will **not** clear swaps containing limited recourse and non-petition provisions.

However, the CFTC did not include these terms in its list of negative specifications. Therefore, although one might reasonably conclude that such swaps are not required to be cleared, there is no definitive authority supporting this view.

ASF CONFIRMATION REQUEST

On May 16, 2013, the ASF submitted a letter to the CFTC's Division of Clearing and Risk (the "DCR") requesting the DCR's confirmation that securitization vehicles may enter into swaps containing limited recourse and non-petition provisions without having to comply with the clearing requirements. On May 21, 2013, the ASF advised its members that in a phone call with the DCR, the DCR confirmed this view. According to ASF, the DCR stated that if no DCO will clear a swap because of its terms, then the swap is not subject to the clearing mandate. However, if parties insert a provision into a swap with the intent of avoiding the clearing requirement, such action may be deemed an evasive abuse of the exemption. Limited recourse and non-petition provisions have been included in swaps for securitization transactions for many years. According to the DCR, they are not evasive.

IT APPEARS THAT ONCE AGAIN THE CFTC'S STAFF HAS ADDRESSED THE CONCERNS OF THE SECURITIZATION INDUSTRY. HOWEVER, IN THE ABSENCE OF A WRITTEN RESPONSE FROM THE CFTC STAFF, AND GIVEN THE AMBIGUOUS LANGUAGE CONTAINED IN THE RELEASE, MARKET PARTICIPANTS AND THEIR COUNSEL WILL HAVE TO DECIDE FOR THEMSELVES HOW COMFORTABLE THEY ARE RELYING ON THE CFTC STAFF'S INFORMAL ADVICE.

[7] 77 Fed. Reg. 74303-74304.

The DCR also advised the ASF that given the DCR's workload, no written confirmation will be provided before the June 10, 2013 effective date. It is unknown if the DCR will provide a written response or other formal interpretation after that date.

CONCLUSION

It appears that once again the CFTC's staff has addressed the concerns of the securitization industry. However, in the absence of a written response from the CFTC staff, and given the ambiguous language contained in the Release, market participants and their counsel will have to decide for themselves how comfortable they are relying on the CFTC staff's informal advice.[8] ■

RICHARD L. FRIED is a partner in the New York office of Stroock & Stroock & Lavan LLP.

[8] *See* "CFTC Provides Commodity Pool Relief for Many Securitization Vehicles," *Stroock Special Bulletin*, December 20, 2012, by Richard L. Fried, available at www.stroock.com/sitecontent.cfm?contentID=58&itemID=1273.

IN RECENT NEWS

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ZSUZSANNA KADAR

EU PROPOSES COMMUNITY LEVEL FATCA-STYLE EXCHANGE OF INFORMATION AGREEMENT

The European Commission, on June 12, proposed expanding the directive on the automatic exchange of information between EU tax administrations to cover dividends, capital gains, and all other forms of financial income and account balances (in addition to information on employment income, director's fees, insurance proceeds and pensions). The proposal would effectively mean that EU member countries would share as much information amongst themselves as they have committed to doing with the U.S. under the Foreign Account Tax Compliance Act (FATCA).

Background. Currently, there are two pieces of EU legislation in effect that pertain to the automatic exchange of tax information within the Union:

1. **The EU Savings Tax Directive.** Under this directive, which took effect in 2005, EU countries automatically exchange information with each other on domestic source interest on investments that is paid to residents of other EU countries.

Austria and Luxembourg have been allowed, for a transitional period, to apply a 35 percent withholding tax instead of engaging in the automatic exchange of information on savings. Luxembourg has recently announced that it would be moving to the automatic exchange of information from 2015.

At the European Council meeting in May 2013, EU leaders agreed to adopt a revised Savings Tax Directive that would expand the current scope to cover investment funds, pensions and innovative financial instruments, and payments made through trusts and foundations.

2. **The Administrative Cooperation Directive.** Under this directive, information would be automatically exchanged by EU tax authorities on income from employment, director's fees, life insurance products, pensions, and immovable property. The directive is applicable as of January 1, 2015. The June 12 proposal would expand the scope of this directive.

Commission's proposal. The proposal expands the scope of the Administrative Cooperation Directive to cover dividends, capital gains, and any other financial income and account balances.

The five categories of income that are already covered by the Administrative Cooperation Directive (employment income, director's fees, life insurance products, pensions, immovable property) will only be shared automatically if the information is readily "available" although there will be no such condition regarding the new income items that are to be added under the proposal. Automatic exchange of information would be mandatory for these added items as EU countries will already be providing such information regarding U.S. account holders under FATCA.

The Commission suggests that the condition of "availability" for the five existing categories of income and capital be reevaluated in 2017.

FACTA triggered the change. EU countries have entered or are currently negotiating intergovernmental agreements (IGAs) with the U.S. under FATCA. The scope of automatic information exchange that EU countries commit to under IGAs for purposes of FATCA is broader than is currently provided for under EU law.

The Administrative Cooperation Directive includes a "most favored nation" clause in its Article 19. According to this clause, EU countries have to provide upon the request of any EU member country the same level of information as they provide third countries, if this is more than provided for under EU law. Therefore, these FATCA agreements could trigger a series of "most favored nation" claims between EU members. With the current proposal the Commission ensures that the scope of automatic exchange of information between Member States is the same as the scope of FATCA, thereby avoiding the need for the most favored nation clause to be invoked.

FATCA: WHAT U.S. MULTINATIONALS NEED TO KNOW

The FATCA rules, which impose significant reporting, documentation and withholding obligations, are not limited to financial institutions as the regulations impose significant and burdensome requirements on U.S. multinationals as well. Below is a summary of the steps U.S. multinationals should take in order to ensure their compliance with FATCA.

Background. The FATCA, which was included in the Hiring Incentives to Restore Employment Act of 2010 (HIRE Act) and signed into law on March 18, 2010, is aimed at preventing U.S. citizens and residents from avoiding U.S. tax through the use of offshore financial accounts.

Under the new provisions, a foreign financial institution (FFI) may enter into an agreement with the IRS, under which the FFI would have certain reporting obligations, including providing information on the FFI's U.S.-held accounts.

An FFI that enters into such an agreement becomes a "participating FFI," while an FFI that does not enter into an agreement with the IRS will become a "nonparticipating FFI" that is subject to 30 percent U.S. withholding tax on all "withholdable payments" from U.S. sources, including dividends, interest and capital gains on the sale of certain U.S. property.

The registration, due diligence, information reporting and withholding obligations under FATCA are generally effective as of January 1, 2014. Entities will have to determine by October 2013 whether they qualify as FFIs and to the extent they do, they need to register with the IRS.

U.S. multinationals may have group companies that could qualify as FFIs, such as treasury centers, captive financing or insurance companies and retirement funds. Although most of the discussion related to FATCA's implications on U.S. payors of U.S. source withholdable payments has been focused on financial institutions, U.S. MNEs and in certain scenarios U.S. citizens and tax residents may have withholding obligations.

FATCA and U. S. multinationals. U.S. multinationals making "withholdable payments" to entities outside of the U.S. have to withhold 30 percent under the FATCA rules unless the entities make certain disclosures to the IRS and to the U.S. withholding agent payor.

For purposes of complying with the FATCA rules, U.S. multinationals are expected to implement certain procedures that may require changes to previously used account payable systems and compliance processes.

Roadmap to compliance. U.S. multinationals should consider taking the following steps to ensure their compliance with FATCA:

Step 1. The multinational has to make a determination as to which of the payments it makes qualify as a "withholdable payment" for purposes of FATCA. Withholdable payments generally include U.S. source fixed or determinable, annual or periodical (FDAP) income, such as interest, dividends, and most types of royalties and rents as well as gross proceeds from the sale of securities that could generate U.S. source income. Income effectively connected to a U.S. trade or business (e.g. fees for certain services), however, will not be subject to withholding under FATCA.

Step 2. Next, the multinational should determine whether the non-U.S. recipient of the withholdable payment is a foreign financial institution ("FFI") or a non-financial foreign entity ("NFFE"). Generally NFFEs that are publicly traded (including their subsidiaries) are not subject to FATCA. Non-publicly traded NFFEs and FFIs, however, must either comply with the disclosure rules or be subject to the 30 percent withholding tax.

Step 3. To the extent the income recipient identified in Step 2 is an FFI, an inquiry must be made to determine whether the FFI is a participating FFI or a non-participating FFI. Non-participating FFIs will be subject to the 30 percent withholding.

Step 4. For NFFE recipients, information should be requested and reported regarding any substantial U.S. owners. If such information is not provided, the payment should be subject to the 30 percent withholding tax.

In order to meet the above requirements, MNEs would have to build out compliance processes that ensures that all necessary determinations, monitoring, documentation and reporting is in place for purposes of complying with the FATCA rules.

DRAFT VERSION OF FORM W-8EXP REFLECTS FATCA CHANGES

The IRS has published a draft revision of Form W-8EXP (Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding), which is filed by qualifying foreign entities that receive certain types of income and want to claim a reduced withholding rate or exemption from withholding. The draft would update the Form to reflect the FATCA.

Background. Generally effective for payments made after Dec. 31, 2012 (but delayed in IRS guidance and proposed regs), the HIRE Act established rules for withholdable payments to foreign financial institutions (FFIs; generally including non U.S. banks, broker-dealers and other custodians, investment vehicles, and certain insurance companies) and for withholdable payments to other foreign entities by adding a new Chapter 4 to the Code (Code Sec. 1471 through Code Sec. 1474). The new rules provide for withholding taxes to enforce new reporting requirements on specified foreign accounts owned by specified U.S. persons or by U.S.-owned foreign entities ("U.S. accounts"). Under Code Sec. 1471(d), a financial account is defined as any depository or custodial account maintained by the financial institution, or any equity or debt interest in the financial institution (other than interests regularly traded on an established securities market).

Under Code Sec. 1471(a), a withholding agent must withhold 30% of certain payments to an FFI unless the FFI has entered into a "FFI agreement" with IRS to, among other things, report certain information with respect to U.S. accounts. Chapter 4 also imposes on withholding agents withholding, documentation, and reporting requirements with respect to certain payments made to certain other foreign entities.

The final FATCA regs were explained in a detailed six-part article published earlier this year.

Form W-8EXP, last revised in 2006, is filed by foreign entities that receive certain types of income. The form is used to: establish that the entity is not a U.S. person; claim that the entity is the beneficial owner of the income for which Form W-8EXP is given; and to claim a reduced rate of, or exemption from, withholding as a foreign government, international organization, foreign central bank of issue, foreign tax-exempt organization, foreign private foundation, or government of a U.S. possession.

New draft of Form W-8EXP. The new draft of Form W-8EXP would reflect the FATCA rules as follows:

- Part I (Identification of Beneficial Owner) would be expanded by adding new section 3 for filing entities to indicate their Chapter 4 (FATCA) status. There are a total of 11 checkboxes (e.g., participating FFI, international organization, 501(c) organization).
- New Part III would be added. Titled "Qualification Statement for Chapter 4 Status (if required)," it carries entries to be completed by nonreporting IGA (intergovernmental agreement) FFIs, territory financial institutions, foreign governments, exempt retirement plans of foreign governments, 501(c) organizations, and passive NFFEs (nonfinancial foreign entities).
- The draft includes a new sentence indicating that the filing entity agrees to submit a new Form W-8EXP within 30 days if any certification made on the form being filed becomes incorrect. ■