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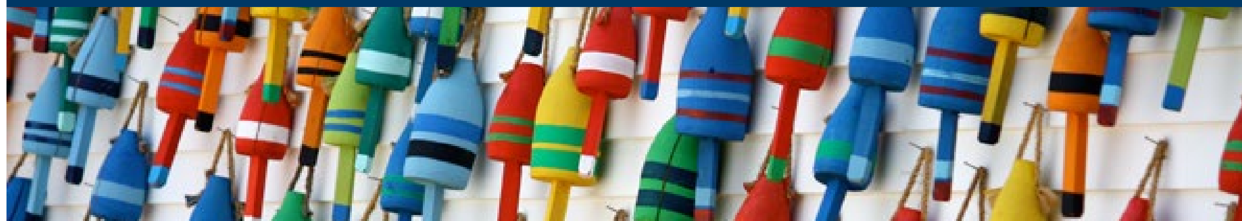

Investment Management Newsletter

IN THIS ISSUE

Application of Regulation D "Bad Actor" Rules to Private Funds and Their Investors 1

A Lifting Fog Around Finders? 5

The Volcker Rule: Regulatory Risks Reduced as Rule Is Finally Adopted 10

The New German Investment Tax Act 14

The New UK Partnership Tax Rules—A Complete Change of Landscape 18

Recent Developments Involving US ERISA Plans 25

SEC Expands Application of Knowledgeable Employee Exemption for Private Funds 27

Futures Trading: The CFTC Overreaches in Its Interpretation of the Antimanipulation Provisions Adopted in Dodd-Frank 30

Application of Regulation D "Bad Actor" Rules to Private Funds and Their Investors

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At the end of 2013, the US Securities and Exchange Commission implemented changes to Rule 506 under Regulation D (Regulation D) promulgated under the US Securities Act of 1933, as amended (Securities Act). The new rules are designed to prevent certain issuers from relying on the Securities Act private offering safe harbor afforded by Regulation D if the issuer and certain other persons, such as underwriters, placement agents, directors, officers and significant owners of the issuer, have been convicted of, or are otherwise being sanctioned for, securities fraud or other specified violations ("bad acts"). These rules are captured in Rule 506(d) of Regulation D and operate to disqualify securities offerings from reliance upon the Regulation D safe harbor if one or more of the specified persons have engaged in bad acts after September 23, 2013 (Effective Date). These changes are continuing to ripple through the market, as issuers and related persons, as well as placement agents and other distributors, adjust to the revised Regulation D.

The Private Offering Safe Harbor

As most readers will be aware, Regulation D provides issuers with a "safe harbor," the ability to offer and sell their securities without registering those securities with the SEC. Under Rule 506, the safe harbor is available for a securities offering as long as the issuer complies with certain statutory conditions and limits the number of nonaccredited investors to no more than 35, among other requirements. While securities issued in reliance upon Regulation D are exempt from registration with the SEC, relying issuers are required to complete and file a "Form D," a brief notice detailing the offering. The recent changes to Rule 506, including the addition of section (d), further limit the availability of the safe harbor by disqualifying issuers from relying on the safe harbor if, after performing due diligence, the issuer becomes aware that it or certain other named persons have engaged in any disqualifying event or "bad act."

Covered Persons

Rule 506(d) requires an issuer to perform due diligence to determine whether any of its "Covered Persons" have been involved in a disqualifying event after the Effective Date. Covered Persons include: any issuer, including any predecessors and affiliate issuers; any director or officer participating in the offering; any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities; any *promoter*[1] connected with the issuer in any capacity at the time of such sale, *investment manager* of an issuer that is a pooled investment fund, any person (such as an *underwriter* or *placement agent*) that has been or will be paid (directly or indirectly) for soliciting purchasers in connection with such sale of securities or any *general partner*, or *managing member* of any such investment manager or solicitor; or any director or officer of any investment manager, solicitor (or the general partner or managing member of any such investment manager or solicitor) that is involved in the proposed offering.

Bad Acts

"Bad acts" are broadly defined as convictions or other regulatory, self-regulatory or judicial determinations that a relevant person has engaged in securities fraud or a comparable fraud-related activity. The look-back periods that apply with respect to bad acts that occur after the Effective Date are divided into three categories; these time periods reflect the perceived severity of the underlying bad acts and include, but are not limited to:

(a) Certain criminal convictions related to the purchase or sale of securities or false filings with the SEC;

(b) US Postal Service false representation orders; court rulings, entered within five years of such sale, that prevent such person from engaging or continuing to engage in any activity:

  (i) In connection with the purchase or sale of any security;

  (ii) Involving false filings with the SEC; or

  (iii) Arising out of the conduct of the business of certain purchasers of securities; or final orders of certain state and federal agencies that:

    (A) Bar the person from:

1 See p. 26 of adopting release. Also 17 CFR 230.261.

(1) Association with an entity regulated by such agency or officer;

(2) Engaging in the business of securities, insurance or banking; or

(3) Engaging in savings association or credit union activities; or

(B) Constitute a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such sale;

(C) Certain SEC disciplinary orders, including fraud-based orders; or

(D) Suspension or expulsion from association with a member of a registered national securities exchange or securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade.

Exceptions and Exemptions From the "Bad Actor" Rules

As part of its adopting release, the SEC introduced a series of transitional rules and exceptions to disqualification for bad acts by an issuer's Covered Persons. The "bad actor" rules do not disqualify an issuer with respect to acts that occurred prior to the Effective Date. However, the rules do require disclosure of prior "bad acts" that would have triggered disqualification but occurred prior to the Effective Date.

In addition, if the SEC determines that it is not necessary under the circumstances to deny an exemption, a bad actor may purchase or sell securities under Rule 506 upon good cause and without prejudice to any other action by the SEC. Similarly, a "bad actor" will not be disqualified under Rule 506 if, before the sale, the court or regulatory authority that entered the relevant order, judgment or decree advises in writing that disqualification under the "bad actor" rules should not arise as a consequence of such order, judgment or decree; or if the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed under the "bad actor" rules.

Bad Actor Diligence Obligations

In order to comply with the revised Rule 506 and avail itself of the Regulation D safe harbor, a prospective issuer must conduct diligence and take steps to ensure that its Covered Persons are not bad actors. This requirement entails a diligence process that must be conducted each time an issuer proposes to offer securities in reliance upon Rule 506 of Regulation D. This diligence process is new to many issuers and their counsel, and the market continues to adjust to the bad actor rules.

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Bad actor rule compliance procedures are continuing to evolve as prospective issuers, placement agents and their counsel develop conventions to address the diligence requirements created by the bad actor rule. Common procedures involve: heightened internal diligence and policing by issuers and their placement agents; revisions to offering documents and investor questionnaires to include targeted bad actor questions; performing

diligence on placement agents, investment managers and other persons involved in private placements on behalf of an issuer; and revising employment agreements with Covered Persons to include termination provisions due to post-Effective Date bad acts.

It is important to remember that a failure to adequately police an issuer's Covered Persons may give rise to rescission rights with respect to an offering that is unable to rely upon Regulation D. The stakes associated with the new rule are high and recent experience suggests that market awareness and issuer and placement agent diligence practices continue to catch up to this important new rule.

For more information, please see the following Kaye Scholer client alerts on the SEC Division of Corporation Finance's Compliance and Disclosure Interpretations of the "bad actor" disqualifications:

SEC Issues New CD+Is Regarding Rule 506 "Bad Actor" Disqualifications (1/6/14)

SEC Issues New CD+Is Regarding Rule 506 "Bad Actor" Disqualifications (12/5/13)

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A Lifting Fog Around Finders?

A version of this article originally appeared in the April 16, 2014 issue of *Law360*.

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This article assesses the murky regulatory world of when and whether a US person can raise capital and receive transaction-based compensation, i.e., compensation tied to the amount of capital raised, without registering as a broker-dealer in the United States.[1]

It observes that the staff of the Securities and Exchange Commission's aggressive stance on when finders have to register as broker-dealers has recently encountered judicial disavowal by US district courts (and certain states' high courts).

In light of these decisions (discussed below), it seems that a person interested in raising capital for an enterprise may be able to obtain: (i) transaction-based compensation if acting as a "passive finder" (acting solely as an introducer); (ii) transaction-based compensation as an "active finder" for a small number of issuers in a few instances in the aggregate; or (iii) transaction-based compensation when raising capital for non-US issuers only from non-US persons outside of the United States.

It cannot be determined if the staff (or other US district courts) will defer to the analyses taken recently by the US district courts or will continue to view the presence of transaction-based compensation as the primary demarcation between a finder and a broker.[2]

Because of this intractable unknown, the engagement agreement between the issuer and the finder should thoroughly specify the nature of the services being provided, the compensation to be paid for each set of services, and include a "severability clause" to prevent the agreement from being found to be void, should some of the services be deemed to be services that can only be conducted by or through a registered broker-dealer.[3]

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1 Other nontransaction-based compensation arrangements and their impact on the analysis of whether a finder needs to register as a broker, and whether fixed-fee services that do not entail raising capital (but may include assistance with business plans, pre-IPO clean-ups and the like) are of less interest to most finders; clearly the honey-pot for finders is obtaining a fee based on the finder's investors' aggregate capital contributions. Accordingly, this article does not address when fixed-fee arrangements may nonetheless require a finder to register as a broker.

2 The staff issued a no-action letter on January 31, 2014 that conditionally allows finders and brokers in private M&A transactions which meet a variety of conditions to receive transaction-based compensation and be actively involved in the acquisition process, M&A Brokers, SEC No-Action Letter (pub. avail. Jan. 31, 2014). The letter expands the narrower staff position taken in the Country Business, Inc. letter which in part required the finder to have a limited role in negotiations and that the transaction represent 100 percent of the private company's outstanding stock or assets, SEC No-Action Letter (pub. avail. Nov. 8, 2006). Historically, M&A stock transactions have been determined by the staff to require registration as a broker where a finder was actively involved and received transaction-based compensation, see, e.g., Hallmark Capital Corporation, SEC No-Action Letter (pub. avail. Jun 11, 2007); John R. Wirthin [sic], SEC No-Action Letter (pub. avail. Jan 19, 1999); and Davenport Management, Inc., SEC No-Action Letter (pub. avail. Apr 13, 1993). Given higher levels of staff flexibility, it is not at all clear that M&A Brokers signals a wider tolerance by the staff for finders operating in the capital-raising arena.

3 *See Torsiello Capital Partners LLC v. Sunshine State Holding Corp.*, 600397/06, 2008 WL 8971330, 10 - 21 (N.Y. Sup. Ct. Apr. 1, 2008) (holding that because the finder was not a registered broker, but its proposed service fell under the SEC's definition of brokerage services, the agreement was void and rescindable and further, ordering the finder to repay the retainer fee it had previously received from the issuer).

A person who is "engaged in the business of effecting transactions in securities for the account of others" is a "broker."[4] A broker effecting transactions in securities (or inducing the purchase or sale of securities) must register as a broker.[5]

The fulcrum phrase for finders is "engaged in the business." The staff has aggressively taken the view, most recently in 2010, that simply receiving transaction-based compensation creates a "salesman's stake" in the capital raised and constitutes being "engaged in the business."[6] Beginning with *SEC v. Kramer*, in 2011, and continuing through 2013, however, US district courts have required more than the presence of a "salesman's stake" for a finder to have to register as a broker.[7]

During 2013, district courts referred back to the multi-pronged "Hansen test" articulated in the 1980s when rejecting the staff's essentially single-pronged approach in Brumberg:

> "whether [the] person (i) is an employee of the [securities'] issuer;
> (ii) receive[s] commissions as opposed to a salary; (iii) is selling or previously sold, the securities of other issuers; (iv) is involved in negotiations between the issuer and the investor; (v) makes valuations as to the merits of the investment or gives advice; and (vi) is an active rather than passive finder of investors."[8]

Although (i) and (ii) above are less pertinent to a third-party finder and more pertinent, for example, to an analysis of a fund selling its own shares under Rule 3a4-1 of the Securities Exchange Act of 1934 (the "Exchange Act"), the balance of these factors is instructive in the contexts of third-party finders and manifestly entails a more complicated factual analysis than simply determining the presence of a "salesman's stake."

The Colorado District Court in a September 2013 case declares that two of these factors should be assigned "heightened weight"—transaction-based compensation and "regularity of participation."[9] Yet the court cautions that "these two factors must not be weighted so heavily so as to subsume the others in the analysis."[10] It then rebukes the Commission for being "unwilling to create the necessary guidance in order to provide clarity."[11] Amen.

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4 The Securities Exchange Act of 1934, as amended (the "Exchange Act") §3(a)(4), 15 U.S.C.A. §78a (West 2014).

5 The Exchange Act, §15(a)(1) and §15(b).

6 Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter (pub. avail. May 17, 2010); *see also* John W. Loofbourrow Associates, Inc., SEC No-Action Letter (pub. avail. June 29, 2006); Wolff Juall Investments, LLC, SEC No-Action Letter (pub. avail. May 17, 2005).

7 *SEC v. Kramer*, 778 F. Supp. 2d 1320, 1337 (M.D. Fla. 2011).

8 *SEC v. Hansen*, 83 CIV. 3692, 1984 WL 2413 (S.D.N.Y. Apr. 6, 1984).

9 *Landegger v. Cohen*, No. 11-CV-01760-WJM-CBS, 2013 WL 5444052, 6-8 (D. Colo. Sept. 30, 2013).

10 *Id* at 6.

11 *Id;* In 1999, the American Bar Association formed its Task Force on Private Placement Broker-Dealers to address smaller companies raising capital in private placements; a theme later and partially (and arguably, after Senate Merkel's amendments, ineffectually) revisited by the crowd funding provisions of the Jumpstart Our Small Businesses (JOBS) Act. The Task Force's report and recommendations were reissued in April 2010 and identify in part a "vast and pervasive 'grey market' of brokerage activity" and "a major disconnect between the various laws and regulations applicable to securities brokerage activities, and the methods and practices actually in daily use by which the vast majority of capital is raised to fund early stage businesses in the United States. Mary M. Sjoquist, et al., *Report and Recommendations of the Task Force on Private Placement Broker-Dealers* (ABA Task Force), A.B.A., 36 (April 28, 2010).

Regularity of participation is asserted to be the "primary indicia of being engaged in the business [of buying and selling securities]."[12] Counting the number of transactions in which a finder engages, however, becomes a slippery part of the analysis. Participation in "dozens" of transactions has been declared to be sufficient regularity, as has "26 transactions over [a] two [-] year period."[13] However, a finder was able to persuade the Court that seven "completed investments" over a two-year period did not reach regularity of participation.[14] Is one no longer enough?

That question cannot be posed independently of the other factors in the Hansen test. If a finder has participated in negotiations and provides valuation advice, and receives transaction-based compensation, she is likely no longer a finder, but a broker.[15] The same result may occur if she foregoes transaction-based compensation, and may occur even if she also refrains from valuation advice.
The only light on the hill here is that if a finder: (i) acts as a passive finder (in the sense of simply introducing potential investors from among persons with whom she had previous business relationships) and (ii) has not previously been compensated as a finder (or perhaps has only a limited and infrequent history of acting as a finder) nor (iii) is otherwise involved at any "key point[s] in the chain of distribution," no registration should be required.[16]

"The line between finder and broker is not always difficult to draw."[17] The recent district court cases can be read to conclude that such a finder can receive transaction-based income and not have to register as (or associate with) a broker-dealer, even if the staff (or other district courts) do not agree.

"Merely bringing together the parties to transactions, even those involving the purchase and sale of securities" is not enough to compel broker registration, even if the finder receives a fee "in proportion to the amount of the sale." The District Court for the Middle District of Florida, after acknowledging and then dismissing the staff's position in Brumberg, concludes:

> "In this instance, [the finder's] conduct consisted of nothing more than bringing together the parties to a transaction. The Commission presented no evidence that [the finder] either participated in the negotiation, discussed the detail of the

12 *Landegger v. Cohen*, at 5, *citing SEC v. Kenton Capital Ltd*, 69 F. Supp. 2d 1, 12 (D.D.C. 1998).

13 *SEC v. Margolin*, 92 CIV. 6307 (PKL), 1992 WL 279735 (S.D.N.Y. Sept. 30, 1992); *Landegger v. Cohen*, at 8.

14 *Landegger v. Cohen*, at 8.

15 *See In the Matter of Ranieri Partners LLC and Donald W. Phillips, Respondents*, Release No. 3563 and 69091, 2013 WL 873219 (March 8, 2013). This decision illustrates exactly what not to do, as the unregistered broker solicited investors on behalf of private funds managed by Ranieri Partners, and his solicitation efforts included: (i) sending private placement memorandum, subscription documents, and due diligence materials to potential investors, (ii) urging at least one investor to consider adjusting its portfolio allocations to accommodate an investment with Raneiri Partners, (iii) providing potential investors with his analysis of Ranieri Partners' funds strategy and performance track record, and (iv) providing potential investors with confidential information relating to the identity of other investors and their capital commitments. Furthermore, the actions implicated the firm and its managing partner, and the SEC went so far as to institute cease and desist proceedings against both, for "failing to oversee" an unregistered broker-dealer engaging in numerous securities transactions and for willfully aiding and abetting the unregistered broker's actions.

16 *SEC v. Hansen*, at 10.

17 *Landegger v. Cohen*, at fn 4.

> transaction, analyzed the financial status of [the issuer] , or promoted an investment in [the issuer] to [the investors]."[18]

While the finder's activities extended for several years, the SEC did not present evidence that the finder had been previously active in other capital raises.

Finders who aggressively engage in activities at key points in the distribution process and receive transaction-based compensation, but do so only in connection with offers and sales of ex-US securities to persons outside of the United States who are not "US persons" (as such terms are defined in Regulation S under the Securities Act of 1933), may also avoid registering as broker-dealers.

The Commission in *SEC v. Benger*, tried to argue that since the finder was acting as a broker in the United States, registration was mandated, yet the district court determined that Congressional intent regarding the reach of the Exchange Act was clearly limited to protecting "American exchange facilities."[19]

If a finder's US activities (viewed collectively or singly) may result in a determination that she is acting as a broker, the finder will need to either (i) register as a broker or (ii) associate with a broker-dealer which is registered. Registration is not only time consuming and expensive but also FINRA routinely requires in new member applications a disclosure of past activities. A recitation of a history of capital-raising activities is likely to result in heightened review of the Form BD by the Financial Industry Regulatory Authority (FINRA).

Associating with a member firm of FINRA will typically result in 10–15 percent of commissions or fees earned by the finder being transferred to the broker-dealer, and will require obtaining the Series 7 and 63 licenses, if not also Series 79. Additional issues as to establishing and allocating costs of a Branch Office/Office of Supervised Jurisdiction also often result.

If a finder's US activities (viewed collectively or singly) may result in a determination that she is acting as a broker, the finder will need to either (i) register as a broker or (ii) associate with a broker-dealer which is registered.

Finally, sponsoring broker-dealers are increasingly requiring finders to use the broker-dealer domain name for even nonregulated business activity, which then means that all of a finder's business is subject to the investigatory powers of FINRA and the Commission.

If a finder anticipates engaging in activities which (when considered in light of previous activities) may well give rise to an issue of the need to register or associate with a broker-dealer, but elects not to do so, she should at a minimum include in her engagement letter with the issuer a "severability clause" so as to avoid the agreement being declared void.[20]

Such a result would become a bar to payment of compensation, and could provide a put right to investors in the transaction with which the finder participated (and hence be injurious

18 *SEC v. Kramer*, at 1337.

19 *SEC v. Benger*, 934 F. Supp. 2d 1008, 1014 (N.D. Ill. 2013).

20 The Exchange Act, § 29(b) provides that a contract that calls for a party to perform an act violative of any securities law is void.

to the issuer as well).[21] The Colorado District Court recently upheld a contract with a finder that engaged in capital-raising activities without registration as a broker, because the contract contained a severability clause.[22] The District Court found no reason not to "sever out that portion of the contract that called for [the finder] to engage in unlawful behavior, and continue to enforce that portion of the contract that called for it to engage in lawful conduct (e.g., developing a business plan and financial model)."[23]

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21 *See Torsiello Capital Partners LLC v. Sunshine State Holding Corp.*, at 10-21.

22 *Sun River Energy, Inc. v. Nelson*, No. 11-CV-00198-MSK-MEH, 2013 WL 1222391 (D. Colo. Mar. 25, 2013).

23 *Id.*

The Volcker Rule: Regulatory Risks Reduced as Rule Is Finally Adopted

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The long-awaited Volcker Rule, formally adopted in December 2013, implements the provisions of section 13 of the Bank Holding Company Act (BHCA), which was added by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Both section 13 of the BHCA and the Volcker Rule are intended to prevent or at least limit activities perceived (correctly or incorrectly) to have contributed to the recent financial crisis. Section 13 limits the ability of insured US depository institutions, bank holding companies, non-US banking organizations with branches or agencies in the US and their respective affiliates to invest in, sponsor or finance hedge funds and private equity funds. Section 13 defines such funds in terms of their investment company registration exemption in reliance on sections 3(c)(1) or 3(c)(7) of the US Investment Company Act of 1940 (Company Act). The Volcker Rule refers to such funds as "covered funds" and to the affected banking organizations as "banking entities." Substantially all hedge funds, most private equity and many real estate[1] investment funds fall within the definition of "covered fund."

The final version of the Volcker Rule contains a complex, interacting series of complete and partial exemptions from the application of the rule to covered funds. The complexity of the interactions makes it difficult to summarize all aspects of the Volcker Rule that apply to covered funds and/or banking entities investing in covered funds and analogous investment vehicles. Instead, this article will limit itself to discussing some of the Volcker Rule's clearer consequences. In the course of the following discussion, it is important to keep in mind that even a person that is not a banking entity can be affected by the Volcker Rule. For example, a sponsor of a non-US fund might be asked to provide special assurances or comfort that a fund is not and will not become subject to the Volcker Rule. Such a sponsor itself may desire protection against the possibility that investors, who find themselves subject to the Volcker Rule or discover that the fund is an impermissible investment for them, must sell or surrender their investment in the fund in a short period of time, something which could materially adversely affect the value of their interest in the fund and potentially the interests held by other investors. We note that Volcker Rule risk allocation is not new; happily, the actual issuance of the rule helps to mitigate some of the perceived risks associated with the rule and its application.

If a fund is completely exempted from the definition of "covered fund," then the prohibitions on ownership, sponsorship and affiliate transactions that otherwise apply to the relationship between a banking entity and a covered fund are of no effect, and any otherwise permissible relationship between a

1 Other exemptions may be available to particular categories of funds. For instance, real estate debt and equity funds may be able to rely upon the exemption afforded by Section 3(c)(5); similarly, natural resources funds may be able to rely upon Section 3(c)(9).

banking entity and the fund is allowed. As a general matter, only four such exemptions[2] are available:

- Reliance on an exemption from registration under the Company Act other than those found in sections 3(c)(1) and 3(c)(7).
- Offering interests in the fund only to non-US persons and making any transfer of interests to a US person void.
- Selling interests predominantly through public offerings outside the US in a non-US fund that is authorized to "offer and sell ownership interests to retail investors in the issuer's home jurisdiction."[3] Additional restrictions apply if the sponsor of the fund is a banking entity that is, or is controlled by, a US banking entity; in addition, to qualify as public, the offering must satisfy certain standards, among which is a prohibition of any requirement that purchasers satisfy a minimum net-worth or net-investment asset standard.
- Registering as an investment company under the Company Act.

The definition of "US person" that applies for purposes of the Volcker Rule is that found in Regulation S of the Securities and Exchange Commission; however, even if an investor in a non-US real estate fund is not a US person under Regulation S, it may be under Rule 4.7 of the Commodity Futures Trading Commission, particularly if the investor is a non-US fund that itself has US investors. Under some circumstances, a non-US fund may be a commodity pool subject to US regulation even if it is exempt from registration as an investment company. Among the "commodity interests" that may cause a pool to be treated as a commodity pool are interest rate and currency derivatives.

Generally speaking, maintaining one of the . . . exemptions requires only a modest compliance effort once the basic decisions have been made.

Funds that invest in direct real estate or real estate debt are often able to rely upon the exception afforded by Section 3(c)(5) of the Company Act, which excludes, among other things, entities "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate," and certain natural resources funds may be able to rely upon the exemption afforded by Section 3(c)(9). Other investment vehicles, upon closer review, also may not constitute 'investment companies' if, for example, less than 40 percent of such vehicles' assets consist of "investment securities."[4] Not surprisingly, Dodd-Frank and the Volcker Rule have fueled an increase in the proportion of funds seeking to rely upon such exceptions from the covered fund definition.

Generally speaking, maintaining one of the above exemptions requires only a modest compliance effort once the basic decisions have been made. However, reliance on the second exemption listed above (for funds offered

2 Non-US pension plans are also excluded from the definition, but that exclusion does not by itself exclude funds in which the pension funds invest. Similarly, separate accounts of insurance companies are excluded from the definition, "provided that no banking entity other than the insurance company participates in the account's profits and losses." Section __.10(c)(6) of the so-called "Common Rules," the provisions of the Volcker Rule adopted by all the responsible federal financial regulators.

3 Section __.10(c)(1)(B) of the Common Rules.

4 See Investment Company Act Section 3(a)(1)(C)(2).

to and held by only non-US persons) requires constant vigilance, including as to the nature of the fund's investments. Many sponsors are now establishing parallel vehicles for US and non-US investors in order to ensure that funds offered to non-US banking entities are not offered to, and do not become owned by, US persons. In this connection, it is important to note that difficult interpretive issues can exist with regard to parallel structures; to non-US funds that invest through funds that target US persons; and to special purpose vehicles that may be established with respect to investments that may be held by multiple investors, including parallel and co-investment funds.

One narrowly defined type of commodity pool is itself treated as a covered fund by the Volcker Rule, something that must be kept in mind when planning fund structures and policies.

In addition, it is important to note that Dodd-Frank and associated regulations have significantly extended the application of Commodity Exchange Act regulation to fund managers. As one might expect, these issues have had some flow-through consequences to investors, including many non-US investors. In addition, one narrowly defined type of commodity pool is itself treated as a covered fund by the Volcker Rule, something that must be kept in mind when planning fund structures and policies.

Partial exemptions exist from the prohibitions on ownership and sponsorship. These exemptions do not, however, affect the application of the prohibition on certain affiliate transactions, making them much less useful than the complete exemptions. Among the partial exemptions that could be useful to non-US sponsors are:

- The so-called *de minimis* exemption, which allows a sponsor to make a large initial investment at the start of a fund's life, as long as that investment is reduced to three percent of the fund's ownership interests within a year and a number of other criteria are satisfied, one of the most important of which is that the fund has to be established and offered in connection with the sponsor's trust, fiduciary, investment advisory or commodity trading advisory services to customers of those services.
- Underwriting and making a market in the ownership interests of a covered fund.
- Ownership or sponsorship of a non-US fund by a non-US banking organization, so long as the majority of its assets, revenue or income are located or derived from outside the US; the activity is conducted in compliance with the otherwise applicable rules about non-US investments by non-US banking organizations; ownership interests are not offered to US persons (although secondary sales to US persons appear to be allowed); the banking entity directly involved in the ownership or sponsorship activity is not, and is not controlled by, a US entity; the relevant decisions are made by personnel located outside the US; the investment is not directly or indirectly booked in the US; and no US affiliate provides any financing. The text of the adopting release makes it reasonably clear that offering ownership interests to US persons can include investing in a parallel fund that targets US persons.

- Ownership or sponsorship, in compliance with any applicable insurance regulations, by an insurance company or an affiliate for the general account or one or more special accounts of the insurer. This partial exemption is available to non-US insurers.

Not only do the partial exemptions listed above not exempt a banking entity from the affiliate transaction prohibitions, but the terms of those prohibitions also make them applicable to certain entities other than owners or sponsors, namely any banking entity that acts, directly or indirectly, as the investment manager, investment adviser or commodity trading advisor of a covered fund. The principal prohibition, commonly referred to as "Super 23A," generally prohibits transactions, such as extensions of credit, between a banking entity and a covered fund that are limited (but not prohibited) by section 23A of the US Federal Reserve Act. One of the most important exceptions to Super 23A is that for properly constructed prime brokerage relationships. Even prime brokerage services, however, are subject to the other affiliate transaction restriction, which subjects all transactions between the affected entities to section 23B of the Federal Reserve Act, which requires that the terms of such transactions be on an "arm's length" basis.

The summary discussion above makes it clear that sponsoring or investing in a private investment fund that may involve banking entities as sponsors or investors requires even more attention to detail than did the traditional concern with becoming affiliated with a bank holding company. This attention should begin in the planning stage and should continue through the formulation of any investment entity documentation, subscription agreement questionnaires and side letters. As adopted, the Volcker Rule complicates life for many fund managers and investors. At this stage, however, its impact has been more muted than many had feared and many secondary investors had hoped.

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The New German Investment Tax Act

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Germany's recent revision of its investment law (Kapitalanlagegesetzbuch, the KAGB), which forms the basis for its Investment Tax Act (Investmentsteuergesetz, the InvStG), has resulted in significant, fundamental changes to the taxation of investment funds. The new rules became effective December 24, 2013 and affect existing and contemplated investment funds, as well as various kinds of other investment vehicles. As a result, investors in German funds and German investors in funds domiciled outside of Germany should monitor their tax status.

General Scope of the New Legislation

The new legislation applies to so-called "investment assets" (*Investmentvermögen*), which are either "alternative investment funds" (AIFs) or UCITS[1]. Whereas UCITS are clearly defined under EU law, the term AIF is much broader and may lead to qualification conflicts under German tax law. Based on the KAGB criteria, an AIF is defined as a collective investment vehicle which raises 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. Furthermore, the undertaking must not qualify as a commercial business outside the financial sector.

The German legislature has made clear that certain investment or fund-related entities, such as holding companies or other SPVs (e.g., securitization vehicles or employee participation schemes) are excluded from the new regime.

Whereas UCITS are clearly defined under EU law, the term AIF is much broader and may lead to qualification conflicts under German tax law.

If an investment vehicle qualifies as an AIF or a UCITS, taxation under the new legislation will depend on whether the vehicle—regardless of being German- or non-German-domiciled—qualifies as: (i) an investment fund (*Investmentfonds*); (ii) an investment partnership (*PersonenInvestitionsgesellschaft*); or (iii) an investment corporation (*Kapital-Investitionsgesellschaft*). Therefore, investors must carefully monitor the applicable provisions of the German investment law as well as of the investment tax law.

1 "Undertakings for the Collective Investment of Transferable Securities," a category of regulated European investment funds that are eligible for certain pan-European passporting and are subject to EU-harmonized investment criteria with regard to financial instruments, securities, and public-announcement duties.

Taxation of Investment Funds (*Investmentfonds*)

For qualification purposes, "investment funds" are all UCITS fulfilling the following criteria, which were explicated for the first time in the new Investment Tax Act. In summary, an investment fund must:

- Be subject to supervision of an authority which supervises collective investment schemes;
- Grant its investors a redemption or termination right once a year, unless the fund is listed on a recognized stock market;
- Invest its monies for the collective account of its investors only and not for its own business purposes; and
- Invest its assets according to the principle of risk diversification, requiring direct or indirect investments in three or more assets with different investment risks.

Further, an investment fund must observe certain thresholds within its investment strategy. Accordingly:

- Ninety percent of the fund value must be invested in certain assets which, for the first time, are listed in the new Investment Tax Act (including, inter alia, shareholdings, financial instruments and precious metals).
- Only 20 percent of the fund value must be invested in shares of non-listed corporations.
- The scope of investments is restricted to shareholdings of less than 10 percent of the share capital of a corporation (which is disadvantageous, inter alia, with regard to tax exemptions under the EU Parent-Subsidiary Directive or a Tax Treaty or with regard to the recently revised dividend-exemption rule under German corporate income tax law).
- Debt financing may only be made on a short-term basis up to an amount of 30 percent of the fund value.
- The respective investment restrictions must be laid down in the terms of the investment fund.
- Certain exemptions apply for PPP investments in renewable energy or real estate projects. In particular, real estate funds are exempt from the participation threshold regarding shareholdings in real estate holding companies. Such funds may generally also take up other loans of up to 50 percent of the fair market value of its real estate investments.

Existing investment vehicles, qualifying as an investment asset under both the old Investment Tax Act and Investment Act as of the cut-off date July 22, 2013, qualify for grandfathering until the end of their first fiscal year ending after July 22, 2016. However, to avoid negative tax consequences, particularly with regard to taxation as an investment corporation (see below), compliance with the new provisions for the qualification as an investment fund should be carefully analyzed.

All other investment vehicles (as for example contemplated future inbound investments of foreign funds, etc.) should also carefully be analyzed beforehand to see if they fulfill the outlined criteria.

Taxation of Investment Partnerships (*Personen-Investitionsgesellschaften*)

If the outlined provisions of the preferential regime do not apply, the vehicle might be taxed as an investment partnership (*Personen-Investitionsgesellschaft*) or investment corporation (*Kapital-Investitionsgesellschaft*).

Investment partnerships are partnerships in the legal form of a German limited partnership (*Kommanditgesellschaft*) or any non-German entity that would be treated as a partnership under German tax law. These entities are subject to the general tax regime applying to a German partnership. Accordingly, for income tax purposes, the tax-relevant income is determined and allocated at the level of the partnership. The taxation itself takes place at the partner level. However, such partnership might be subject to an additional layer of German trade tax (*Gewerbesteuer*).

Taxation of Investment Corporations (*Kapital-Investitionsgesellschaften*)

UCITS or AIFs, not taxed as investment funds or investment partnerships, are taxed as an investment corporation. Such treatment may apply, for example, to a Luxembourg FCP or SICAV that does not fulfill the criteria set out above. Basically, the general rules of German corporate income tax law apply to such entities. Thus, the entity should be subject to German corporate income tax at 15 percent and, provided a permanent establishment is given, also to German trade tax at an additional +/-15 percent.

Further, corporate or individual investors allocating the shareholding to their business assets should note the following: To benefit from the 95 percent (corporate investors) resp. 40 percent (individual investors) tax exemption for dividends[2] or capital gains, such investors must provide evidence that:

- The investment corporation is taxed within the EU or EEA; or
- If the corporation is resident in a third [non-EU or EEA] country, that it is subject to taxation at a minimum rate of 15 percent.

In addition, investors or domestic investment corporations may be taxed under the German CFC-Rules with certain passive income received from shareholdings in low-taxed foreign corporations. Such income (including inter alia interest payments or income from mere asset administrating activities) would be—after deduction of the foreign tax—directly allocated and taxed at the level of the domestic shareholder.

Opt-ins/Opt-outs From the Privileged Regime

An investment vehicle may alter its tax status, leading to taxation as an investment partnership/investment corporation or *vice versa* leading to taxation as an investment fund.

Accordingly, an investment partnership/investment corporation may apply to be taxed under the privileged regime if it fulfills the criteria outlined above. On the other hand, an investment fund that no longer qualifies as

2 For corporate investors, the 95-percent exemption only applies on shareholdings of 10 percent or more in the respective corporation.

an investment fund as *ultima ratio* forfeits the privileged tax status. Consequently, it will then be taxed as an investment corporation or an investment partnership for a minimum period of three years. The new rules apply for open-ended funds from the fiscal year after the tax authorities have finally assessed the nonprivileged status. For specialized investment funds, the taxation already starts after the fiscal year, ending before the failure with the outlined criteria occurs.

Conclusion

German investment taxation has undergone fundamental changes. Investors and fund managers should carefully assess whether:

- A newly organized investment vehicle would qualify as an investment fund, and be subject to the preferential German transparent tax regime, based inter alia upon such entity's proposed investment program and expected portfolio characteristics; and
- Existing investment vehicles, which currently benefit from the transitional grandfathering regime, will fulfill the "investment fund" criteria no later than the first fiscal year ending after June 22, 2016.

Otherwise, an investment vehicle might, for example, be subject to the generally more detrimental taxation as an investment corporation, with the potential risk of double taxation at the level of the respective investment vehicle as well as well as at investor level.

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The New UK Partnership Tax Rules—A Complete Change of Landscape

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Last year, in Budget 2013, the UK government commenced a consultation (Consultation) on two anti-avoidance measures regarding UK incorporated limited liability partnerships (LLPs) and general (i.e., UK and non-UK based) partnerships. Although nearly all professional and industry bodies, including the Alternative Investment Management Association, the British Private Equity & Venture Capital Association and the City of London Law Society, argued against the measures during the Consultation Process and in particular their hasty adoption (even the House of Lords, the UK's Upper Legislative Chamber, called for postponement), HMRC resisted all calls for deferred introduction. The measures will now come into force with effect from 6 April 2014 once the Finance Bill 2014 becomes law this Summer.

What Are the Measures About?

Broadly, in the context of investment management, the government intends to address what it perceives to be two forms of abuse of the taxation regime for partnerships and UK-incorporated LLPs:

1. The automatic and favourable treatment of members (partners) of UK LLPs as self-employed for tax purposes, while in HMRC's view many members are more akin to employees in status and remuneration; and
2. The ability of any partnerships (including UK LLPs) to allocate profits to a corporate member (that benefits from the lower corporation tax rate) where in HMRC's view the profits of the corporate in reality derive from an individual's efforts who diverts such profits to the corporate for tax purposes, and is able to access the corporate's profits at a benefit.

There are three aspects of the new provisions that are particularly relevant to investment management firms who carry on business in the UK as UK partnerships or LLPs: the "salaried member" rules, the corporate member allocation regime, and deferral under the Alternative Investment Funds Manager Directive (AIFMD) or similar regime.

1. Salaried Members of UK LLPs

This measure applies to UK incorporated LLPs. Historically, HMRC accepted that the LLP tax legislation for UK incorporated LLPs automatically treats individual members of LLPs as self-employed. Conversely, partners in any other type of partnership had to meet the partnership tests known as the "badges of partnership"—e.g., sharing in profits and losses of the business, taking part in business decisions, providing capital, etc. in order to be accepted as self-employed. A key tax (and therefore financial) difference between the treatment of individuals as "partners" and "employees" is that payments to the latter are subject to an additional 13.8 percent employer's National Insurance contributions (NICs) that are payable by the employer, but do not apply to "partners." In the government's view, the automatic LLP treatment as members has

been abused, with many individuals becoming LLP members solely to avoid the 13.8 percent employer's NIC.

Under the new legislation, individual members of a UK LLP will be treated as "salaried members"—i.e., employees, for tax purposes if three conditions are all met. (Accordingly, individuals will continue to be regarded as self-employed partners if they breach any one of the conditions.) Bizarrely, HMRC have chosen to formulate an entirely new set of highly complex and often uncertain rules to determine employment status, rather than applying the badges of partnership that apply to all other partnerships. The three new conditions are:

a) **Condition A:** Under the arrangements pursuant to which a member performs services for the LLP, it is reasonable to expect that at least 80 percent of the amounts payable by the LLP to the member over the period of the arrangements will be "disguised salary."

   Broadly, an amount is "disguised salary" if the amount is fixed or, if it is variable, varied without reference to the overall profits and losses of the LLP (e.g., varied by reference to a part of the profits), or if it is not in practice affected by such overall profits and losses.

   The condition is tested on 6 April 2014 or when the individual becomes a member of the LLP, if later, and again if there is a change in circumstances. A member who does not perform services for the LLP (e.g., a retired or sleeping partner) is not affected by this condition and, therefore, will not be classified as an employee.

   There are many difficulties in applying the condition to customary LLP remuneration structures. To compound the difficulties, the actual legislation is short, with HMRC "illustrating" the intended effect through guidance and, in particular, detailed examples (which are not necessarily coherent or complete). As a result, there are profound uncertainties in the law and guidance.

   While the application may be clear in relatively straightforward circumstances, the guidance (and even more so, the legislation) does not deal with scenarios involving sophisticated investment management firms and their often more complex remuneration methods.

HMRC have chosen to formulate an entirely new set of highly complex and often uncertain rules to determine employment status, rather than applying the badges of partnership that apply to all other partnerships.

   Remuneration structures such as a guaranteed minimum profit share, caps on profit shares and participation in discretionary bonus pools or business units may be open to different interpretations depending on all the circumstances. To provide one example, under the guidance, remuneration calculated *only* by reference to personal performance (a percentage of a member's trading profits, for example) or the results of part of the business (such as a share of net fees from a particular fund) will meet the condition as disguised salary. If instead these or other measures of performance produce an entitlement to a *share of LLP profits*, the

resulting amount may be variable and not disguised salary, so that Condition A is not met. How to distinguish between these two scenarios in practice is one of the many difficulties the guidance poses, and may well come down to specific drafting of the LLP documentation rather than clear legislation. Thus, a small change in the way that an entitlement to remuneration is expressed in an LLP agreement or side letter could affect the analysis.

b) **Condition B:** The member does not, under the arrangements between the LLP and its members, have "significant influence" over the affairs of the LLP.

This is possibly the most "obscure" of the three conditions. "Significant influence" looks at the ability of members to have their views taken into account with some degree of certainty in the running of the LLP. This may be the case in a range of situations that could include participating in LLP members meetings or a management committee—or even where, as a key partner, an individual is consulted on important matters outside any formal management structure.

However, the guidance is fairly limited on this point. To fail this condition, HMRC guidance provides that it is likely to require more than a right, as an LLP member, to vote on commonly reserved matters such as a change in the nature of the business, etc.; this would not be viewed as significant influence. However, many professional partnerships are precisely run with major vetoes structures, without any question whether those who are made partners are employees. A somewhat bizarre consequence is that, in practice, it may be easier for a smaller partnership with only a handful of partners to show that its members exercise "significant influence," compared to larger partnerships.

Somewhat helpfully, HMRC have permitted the alignment of tax with FCA rules, whereby persons who hold CF3 (chief executive function) or CF8 (apportionment and oversight function) would have significant influence; but in line with HMRC, a CF4 (partner function) is not sufficient by itself.

Finally, HMRC guidance on Condition B further provides that a "realistic view" of the facts is to be taken in each case. This sounds sensible but, among other flaws, fails to take account of the difficulty of actually proving that someone exercises significant influence outside a clear function even where, in practice, many members defer to such person's judgment.

c) **Condition C:** At the relevant time, the member's contribution to the capital of the LLP is less than 25 percent of the amount of disguised salary which is reasonable to expect will be payable by the LLP to the member for the performance of services during the tax year.

This is the most technical of the three conditions. Broadly, in calculating capital, amounts will be treated by the LLP as added to a member's capital where the member is not entitled to draw these out or receive them back while a member of the LLP.

There is a three-month grace period from 6 April 2014 so that existing members of UK LLPs who pay in capital will be regarded as having done so from that date. For members joining an LLP subsequently, capital must be paid in within two months in order to be treated as paid in when they became members.

Nevertheless, while at first sight easy to calculate (and to meet), the third condition requires a clearly defined amount of "disguised salary" for calculation purposes against which the capital requirement is measured. While this will be clear in some circumstances (e.g., fixed profit shares), in other cases members may dispute the amount of a member's remuneration that constitutes "disguised salary," or it is simply not clear—the question therefore arises whether a certain level of capital constitutes a deemed "admission" of disguised salary.

What Are the Consequences if All Conditions Are Met?

If the three Conditions are satisfied regarding a member at any relevant time, the member will be treated for tax purposes as a "salaried member" in respect of the relevant remuneration, i.e., liable to employment taxes. As a result, amounts paid to the employee in respect of the (deemed) employment will be subject to deduction of income tax and employee's NICs under the Pay-As-You-Earn (PAYE) employee withholding regime, and 13.8 percent employer NICs become payable by the LLP on such amount in addition—a major operating cost to the LLP.

The legislation also includes a targeted anti-avoidance rule (TAAR) in order to counter measures that seeks to undermine the effect of the salaried members provisions.

Where there is a risk that all conditions may be met, it is advisable for investment managers to review the LLP agreement and other documents governing the relationship between the LLP and members, such as side letters, business plans, etc. to clarify the status and advise on any remedial measures that may be available.

2. Partnerships With Corporate Members

This measure applies to *any* partnership (including UK-incorporated and foreign LLPs) that has both individuals and companies (or other non-natural persons) as partners. The provisions are intended to counter arrangements under which profits are allocated to a corporate member and would, after deduction of corporation tax, be accessible by individual members (potentially without further tax being due), where HMRC considers that the profits constitute the fruit of an individual's efforts and are essentially allocated to a corporate member to benefit from the lower corporation tax rate of approximately 20 percent.

The anti-avoidance legislation will apply where one of two conditions is met:

a) **Condition X:** It is "reasonable to suppose" that amounts representing an individual member's share of the partnership's profits, the provision of which to the member has been deferred, are included in the share of profits paid to a nonindividual member (i.e., the corporate) and in consequence both the individual's profit share and the tax payable by those members are reduced.

b) **Condition Y:** The profit share allocated to a nonindividual member exceeds the notional profit that it would receive, calculated on the basis of the capital contributed to the partnership by it or the services provided to the partnership by it, and (i) an individual member has the "power to enjoy" such profit share and (ii) it is "reasonable to suppose" that all or part of the nonindividual member's profit share is attributable to the individual member's power to enjoy (and that both the individual's profit share and the tax payable by those members are reduced).

If either of the two conditions are met, the individual member's profit share is notionally increased by HMRC on a "just and reasonable" basis by so much of the nonindividual member's profit share as it is reasonable to suppose is attributable to the individual member's deferred profits (where Condition X applies) or power to enjoy the nonindividual member's excess profits (where Condition Y applies). One obvious difficulty with the legislation is that the "reasonable to suppose" test can arguably ignore the actual facts, and equally, what is "just and reasonable" is open to debate where HMRC and individuals may well have different views.

What the new anti-avoidance legislation effectively does is ignore the LLP's allocation of profits to corporate members in all but a handful of limited circumstances, and instead tax the amounts to income tax in the hands of individual partners.

Further, the legislation does not contain any requirement that the arrangements must have a tax-avoidance motive. Rather, the provisions are far reaching and apply to genuine commercial structures, such as to warehoused amounts not yet vested under a remuneration-deferred arrangement, or very common working capital retention in the business.

In summary, what the new anti-avoidance legislation effectively does is ignore the LLP's allocation of profits to corporate members in all but a handful of limited circumstances, and instead tax the amounts to income tax in the hands of individual partners.

HMRC have remained immune to calls for deferral of the new corporate member measures, given their highly adverse impact on what are commonly regarded as genuine commercial arrangements as well as the enormous legislative uncertainties. The reason provided to industry representatives by HMRC why deferral of the measures was not possible was that the income expected to be collected by these measures has already been booked—a highly unsatisfactory explanation (which may not be of HMRC's making alone), particularly given the legislative quagmire and the damage to the integrity of the legal system that has been created.

3. Alternative Investment Managers: Deferred Remuneration

One of the circumstances in which profits of a UK LLP or other partnership have in the past been allocated to a corporate member is where profits are earmarked for the entitlement of an individual member but payment of the amount to such member is deferred either in compliance with a regulatory regime or under a voluntary arrangement set up

for commercial incentivisation or investor-demand purposes. In fact, under the remuneration regime imposed by the AIFMD, a substantial part of an individual member's variable remuneration may, going forward, be required to be deferred and/or received in the form of fund equity.

The Financial Conduct Authority (FCA) has allowed deferral to be operated on a "net of tax" basis. If the gross amount were allocated to an individual member at the outset, such individual member whose remuneration is deferred or in the form of fund equities subject to a retention period would potentially have a tax liability in excess of the cash remuneration to which he is entitled.

The advantage of the statutory arrangement is that it is accepted by the FCA as a valid deferral or retention by the individual member, even though the LLP or partnership (rather than the individual) pays the income tax out of the amount deferred or retained.

Given the introduction of the new anti-avoidance measures, it is a relief for AIFM firms that the new tax regime provides a solution to this particular issue. Specifically, the legislation allows deferred profits or profits receivable in the form of fund equity subject to a retention period of at least six months to be notionally allocated for tax purposes to the LLP or partnership, as if the LLP or partnership were a taxable member itself. The LLP or partnership then pays tax (at the highest marginal income tax rate of 45 percent) on these profits. The tax paid is available as a tax credit when the profits subsequently vest in the member for whom they were originally earmarked (and the member pays self-employed earners NICs at that point). To the extent that the profits do not vest because the deferral condition is failed, the upfront profits are treated as a taxed capital sum, which may be retained by the LLP/partnership or corporate member or be re-allocated to another member without further tax or NICs charge (but without any repayment of the tax).

The advantage of the statutory arrangement is that it is accepted by the FCA as a valid deferral or retention by the individual member, even though the LLP or partnership (rather than the individual) pays the income tax out of the amount deferred or retained. It also avoids the common problem of double taxation if the profits are subsequently transferred to another member.

Where the amount vests, the individual member is required to it in his tax return for the year of receipt , either as an additional part of the member's share of profits of the trade or as a post-cessation receipt, if the member is no longer carrying on the trade and receives a credit for the tax paid. The member may have additional tax to pay or be entitled to a repayment of tax depending upon his personal circumstances.

In order to benefit from the treatment, the AIFM firm must elect for the statutory arrangement to apply, within six months after the end of the relevant first accounting period. The election then remains in force until withdrawn.

Individual members may make a claim in respect of each tax year to allocate all or part of the relevant profits to the AIFM firm and so reduce their taxable profits.

Where the variable remuneration is received in the form of fund equities (and the tax paid by the LLP or partnership), these are treated for capital gains tax purposes as disposed of by the LLP or partnership and acquired by the individual member for an amount equal to the value of the profits allocated to the LLP or partnership, less the tax paid.

Conclusion

Overall, it is difficult to overstate the impact of the new partnership tax measures. Not only are they widely unpopular, their impact and the draft legislation and guidance are, at best, uncertain and at worst (at least partially) a complete muddle.

One obvious consequence of the new measures, the imposition of tax on partnerships, constitutes a fundamental and sadly historic departure from the century-old UK principle of partnerships being tax-transparent and not subject to tax. Moreover, there has not been enough time to think through some of the effects—indeed, the law of unintended consequences beckons highly. Thus, the question of how double tax credits, and tax-treaty relief generally, are intended to work—or how UK and US tax rules interact—has simply not been addressed. It is also plainly wrong for HMRC to effectively legislate by issuing guidance and examples that seek to explain deficient legislation. There is much tidying up to do on legislation and guidance; tinkering around the margins will no doubt be plentiful, but the damage to the system is done.

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Recent Developments Involving US ERISA Plans

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SEC and DOL Impose Sanctions Relating to Transactions With ERISA Plans in a $21 Million Settlement

Earlier in 2014, both the Department of Labor and the Securities and Exchange Commission announced settlements with Western Asset Management ("Adviser") involving alleged trading errors with plans subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA) and alleged improper cross-trading under the Investment Company Act of 1940 (1940 Act) and the Advisers Act. This article briefly summarizes select findings as discussed in the SEC's orders. The Adviser has neither admitted nor denied the findings.

The settlements resulted from alleged trading errors as a result of coding certain pass-through trust securities as eligible for purchase by ERISA plans, although the prospectus indicated that ERISA plans could not purchase the securities. Under the Adviser's automated compliance system, the pass-through securities were originally coded as an asset-backed security that was not eligible for sale to plans. After the first offering of the securities, the coding was changed from an "asset-backed security" to "corporate debt," and the compliance system automatically coded the securities as available for purchase by plans. In October 2008, the Adviser was notified by a former institutional client that the securities were not eligible for purchase by plans, and the Adviser changed the designation in its compliance coding system.

The Adviser investigated the issue but did not notify the ERISA plans. The three-month internal investigation concluded that while the purchase by the plans had caused a breach of an issuer-imposed offering restriction, it was not an "error" within the meaning of their correction policy and that there was no violation of ERISA. A committee at the Adviser reviewed the investigatory outcome, concluding that there had not been a breach of guidelines or a prohibited transaction under ERISA. The Adviser sold the positions held by the ERISA plans in May and June 2009 at a materially lower price than the purchase price, but did not notify the clients of the erroneous purchase of the securities until August 2010. The DOL and the SEC investigated for four years before agreeing to settle with the Adviser under the January 2014 order.

It is important to analyze closely whether any restrictions apply in a sale to an ERISA plan or a fund which is considered to be a "plan asset fund."

As a result of the settlement, the Adviser agreed to make a distribution of approximately $10 million to the ERISA plans. The Adviser also agreed to pay civil penalties of $1 million to both the DOL and the SEC, and to engage a compliance consultant. The SEC and the Adviser also settled issues relating to cross-trading, resulting in the Adviser making distributions of approximately $7.4 million to clients and civil penalties of approximately $1.6 in total to the SEC and DOL.

Investments and trades involving ERISA plans are subject to a complex structure of rules. As highlighted by the findings in the SEC orders, it is important to analyze closely whether any restrictions apply in a sale to an ERISA plan or a fund which is considered to be a "plan asset fund."

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DOL Proposes Changes to Fee Disclosure Regulation

Investment advisers and other service providers to ERISA plans, and funds subject to ERISA, may yet again have to update their compliance with ERISA disclosure rules if the DOL adopts proposed changes. The DOL's "fee disclosure" rules have been in effect since 2012, and most providers have established a routine for compliance for their ERISA plan investors. As anticipated, the DOL recently proposed regulations requiring service providers to provide ERISA plan investors a guide or "roadmap" to "lengthy" complicated documents, if necessary, for the investors to understand the fee provisions of the services (called "408(b)(2) disclosure" after the section of ERISA). The DOL has invited comments, including any on when a roadmap would be necessary.

SEC Expands Application of Knowledgeable Employee Exemption for Private Funds

Patrick A. Michel Counsel

The Division of Investment Management (the Staff) of the Securities and Exchange Commission has significantly expanded the scope of the application of the definition of "Knowledgeable Employee" set forth in Rule 3c-5 of the Investment Company Act of 1940, as amended (Investment Company Act). In a No-Action Letter issued on February 6, 2014 in response to a request by the Managed Funds Association (the MFA Letter), the Staff expanded its interpretation of the definition of "Knowledgeable Employee" to take a more permissive approach to the concepts of business unit (and analogous groups within an investment adviser), policy-making functions and participation in investment activities. The result substantially increases the extent to which persons engaged in investment management activities on behalf of investment funds that rely upon Sections 3(c)(1) or (7) of the Investment Company Act may invest in such funds.

Background

A substantial number of investment funds that raise money from US investors and are not registered in accordance with the Investment Company Act, including most hedge funds, private equity funds and many other types of pooled investment vehicles, rely upon the exclusions afforded by Sections 3(c)(1) or (7) of the Investment Company Act. Section 3(c)(1) excludes a fund whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons, and that is not making and does not presently propose to make a public offering of its securities. Section 3(c)(7) excludes a fund whose outstanding securities are exclusively owned by persons who, at the time of acquisition, are "qualified purchasers," and that is not making and does not presently propose to make a public offering of its securities. Pursuant to Rule 3c-5, Knowledgeable Employees are not counted toward the 100-person limit with respect to a 3(c)(1) fund and are not required to be qualified purchasers with respect to a 3(c)(7) fund. Funds that are exempt under Section 3(c)(1) and Section 3(c)(7) are treated as a "Covered Company" under Rule 3c-5.

Executive Officers and Policy-Making Employees

The first category of Knowledgeable Employees includes "Executive Officers," defined in the rule as the president, any vice presidents in charge of a principal business unit, division or function, and employees who perform policy-making functions for a Covered Company or for an affiliated person that manages the investment activities of a Covered Company (any such person, an "Affiliated Management Person").

Principal Business Unit

The Staff clarified that whether a business unit, division, or function qualifies as a principal business unit, division, or function should be determined through a facts and circumstances analysis of the investment manager's business operations. While not all business units, divisions, or functions are necessarily principal, it is possible that several business

units, divisions, or functions could each be a principal unit, division, or function depending on the facts and circumstances.

Employees Who Make Policy

The Staff clarified that employees without senior manager titles may satisfy the definition of "Executive Officer" by serving as a member of a group or a committee that develops and adopts an investment manager's policies, even if such employees do not perform policy-making functions by themselves outside of participation in such group or committee. For example, employees that serve as active members of a valuation committee may qualify as executive officers under the rule.

Participation in Investment Activities

The second category of Knowledgeable Employees includes those employees of a Covered Company or an Affiliated Management Person who regularly participates in the investment activities of such Covered Company, other Covered Companies, or investment companies managed by such Affiliated Management Person, provided that they have been performing such functions and duties for or on behalf of such Covered Company or an Affiliated Management Person, or substantially similar functions or duties, for or on behalf of another company, for at least 12 months ("Participating Employees").

Research Analysts

The Staff clarified that this category of Knowledgeable Employee could include a research analyst who researches a portion of a Covered Company's portfolio and provides analysis or advice to the portfolio manager with respect to only that portion.

Participating Employees

The Staff reiterated that the ultimate determination of whether an individual participates in the investment decisions of a Covered Company is a factual determination that must be made on a case-by-case basis, but they agreed that: (i) a member of the analytical or risk team; (ii) a trader; (iii) a tax professional; and (iv) an attorney whose analysis or advice is material to the portfolio manager's investment decisions could fall within the category of Participating Employees if they regularly perform such functions or duties and have been doing so for at least 12 months.

Separate Accounts

For purposes of the rule, an employee's participation in the investment activities of a separate account (rather than a private fund) will qualify such employee for knowledgeable-employee status if the separate account is established for a client that is a "qualified client" and is otherwise eligible to invest in the Covered Companies advised by the investment adviser or its relying advisers, and the account pursues an investment objective or strategy substantially similar to one pursued by one or more of the investment adviser's or relying adviser's Covered Companies.

Employees of Related Advisers in Control Relationships

The Staff accepted arguments made in the MFA Letter that if a filing adviser and its relying adviser(s) collectively conduct a single advisory business as described in a letter

issued by the Staff in 2012[1], then each of the filing adviser and relying adviser(s) may be an Affiliated Management Person of a Covered Company. The Staff stated that an employee of affiliated advisers that are deemed to conduct a single advisory business, under the terms of the prior guidance cited, would generally have significant access to information about the Covered Companies managed by the other affiliated advisers within the single advisory business. As a result, knowledgeable employees of a filing adviser or any of its relying advisers may be treated as a knowledgeable employee with respect to any Covered Company managed by the filing adviser or its relying advisers, provided that the employees meet the other conditions of the rule.

Conclusion

The interpretive guidance provided in the MFA Letter represents a significant step on the part of the Staff to expand the application of Rule 3c-5. The letter reduces the uncertainty relating to employee investments in Covered Companies. Over time, numerous individuals who serve as executive officers of an investment adviser or its relying advisers, as well as many individuals who engage in portfolio management activities on behalf of such advisers, should be able to invest in Covered Companies without jeopardizing those entities' ability to rely upon Sections 3(c)(1) or (7) of the Investment Company Act.

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1 SEC Staff citing the American Bar Association Section of Business Law, SEC No-Action Letter (Jan. 18, 2012). In this letter, the Staff established criteria pursuant to which a "filing adviser" could file a single Form ADV on behalf of itself and "relying advisers" that are affiliated with the filing adviser as part of a single advisory business.

Futures Trading: The CFTC Overreaches in Its Interpretation of the Antimanipulation Provisions Adopted in Dodd-Frank

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In its recent settlement with JPMorgan Chase Bank N.A. regarding its "London Whale" trading losses, the Commodity Futures Trading Commission (the CFTC) articulated and seemingly adopted an overly expansive view of its power to control trading conduct in the futures and derivatives markets. The CFTC's aggressive interpretation of the Dodd-Frank Wall Street Reform and Consumer Protection Act's addition of a new antimanipulation provision to the Commodity Exchange Act (the CEA) gives rise to substantial risks and unintended consequences, including the chilling of legitimate market activity that is critical to market liquidity. This article examines the validity of the CFTC's expansive view of its authority and concludes with some observations about its implications for market participants.

Background

Until 2010, the CFTC's authority to commence enforcement actions for manipulation was restricted to provisions in Section 6(c) of the CEA prohibiting a party from manipulating or attempting to manipulate the price of a commodity. The CFTC for years had chafed under this restriction and sought to broaden its authority.

With enactment of the Dodd-Frank Act, Congress seemingly granted the CFTC's wish. As a result, the CFTC was freed of the obligation to prove an intent to manipulate. As an alternative, the CFTC may prove that a party engaged in prohibited conduct with an intent to deceive the marketplace.

Congress created Section 6(c)(1) of the CEA to make it "unlawful for any person, directly or indirectly, to use or employ, or attempt to use or employ . . . any manipulative or deceptive device or contrivance . . . ." In accordance with Congress' charge a year later, the CFTC adopted Rule 180.1, which states in pertinent part:

1. It shall be unlawful for any person, directly or indirectly, in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, to intentionally or recklessly:
   (a) Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud . . .

The JPMorgan London Whale Settlement

The CFTC used this new section of the CEA and Rule 180.1 as the basis for its settlement with JPMorgan regarding the London Whale trading losses. In the CFTC's Order, the CFTC found that the traders had "recklessly used or employed manipulative devices and contrivances in connection with swaps in violation

of Section 6(c)(1) of the [CEA], 7 U.S.C. § 9 (2012), and Regulation 180.1, 17 C.F.R. § 180.1 (2012)."[1] When the CFTC approved the consent Order with JPMorgan, it was noteworthy that Commissioner Scott D. O'Malia dissented because he observed, among other things:

> [S]ince the 'manipulative device' charge has not been tested before, I strongly believe that the courts must decide this case of first impression in order to set precedent and to guide both the Commission and market participants.[2]

Commissioner O'Malia continued:

> Because the settlement Order does not allege that JPMorgan engaged in manipulative or fraudulent conduct, I believe the [CFTC] needs to do a better job of explaining why the company's aggressive trading strategy constitutes a 'manipulative device.'
>
> Regrettably, neither the CEA nor [the CFTC] regulations define a 'manipulative device.' This lack of a legal standard makes it even more difficult to determine whether JPMorgan engaged in a reckless behavior that put the company at risk or whether such behavior constitutes a 'manipulative device.'
>
> Although, some case law supports the [CFTC's] conclusion that any device that is intentionally employed to distort a pricing relationship may be manipulative, the [CFTC] has failed to produce data or conduct a more careful evaluation of the actual price to determine whether JPMorgan's conduct distorted the price of certain CDX indices.
>
> This problem is compounded even more by the fact that the allegations in the settlement Order center on bilateral or over-the-counter trading. Given this trading environment, I am not clear how the [CFTC] can distinguish between 'real' and 'distorted' prices if the trades were executed through bilateral negotiations.[3]

That question remains unresolved, and the CFTC's statements in the Order only compound the uncertainty about which Commissioner O'Malia lamented.

The Meaning of the CFTC's Rule 180.1

In its proposing and promulgating releases regarding Rule 180.1, the CFTC acknowledged that Section 6(c)(1) is modeled on Section 10(b) of the 1934 Securities Exchange Act, which "has been interpreted as a broad, 'catch-all' prohibition on fraud and manipulation."[4] Accordingly, the CFTC stated:

> Likewise, the [CFTC] proposes to interpret CEA section 6(c)(1) as a broad, catch-all provision reaching fraud in all of its forms—that is, intentional or reckless *conduct that deceives or defrauds market participants*.[5]

1 Order, *In re JPMorgan Chase Bank, N.A.*, CFTC Docket No. 14-01, at 15 (CFTC Oct. 16, 2013) (JPMorgan Order).

2 Statement of Commissioner Scott D. O'Malia, dated Oct. 15, 2013.

3 *Id.* (footnote omitted).

4 Prohibition of Market Manipulation, 75 Fed. Reg. 67657, 67658 (CFTC Nov. 3, 2010).

5 *Id.* (emphasis added).

Consistent with that objective, the CFTC modified Rule 180.1 on the SEC's Rule 10b-5.[6]

With respect to the phrase "manipulative or deceptive device or contrivance," the CFTC observed, citing to the US Supreme Court's decision in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 494 (1977):

> For example, this provision has been interpreted in the SEC Rule 10b-5 context as prohibiting all practices that are *intended* to mislead investors by *artificially* affecting market activity. Consistent with judicial interpretations of the scope of SEC Rule 10b-5, the [CFTC] proposes that subsection (c)(i) be given a broad, remedial reading, embracing the use or employment, or attempted use or employment, of any manipulative or deceptive contrivance for the purpose of impairing, obstructing, or defeating the integrity of the markets subject to the jurisdiction of the [CFTC].[7]

When it promulgated the rule, the CFTC stated:

> To account for the differences between the securities markets and the derivative markets, the [CFTC] will be guided, but not controlled, by the substantial body of judicial precedent applying the comparable language of SEC Rule 10b-5. Such extensive judicial review serves as an important benefit to the [CFTC] and provides the public with increased certainty because the terms of Exchange Act Section 10(b) and SEC Rule 10b-5 have withstood challenges to their constitutionality in both civil and criminal matters.[8]

The CFTC declared that it intended to interpret and apply both Section 6(c)(1) and Rule 180.1 "not technically and restrictively, but flexibly to effectuate its remedial purposes."[9]

Those comments are the totality of the CFTC's formal guidance concerning Rule 180.1 and the meaning of a "manipulative or deceptive device." According to the CFTC's statements in its 2010 proposing release, the device must be "intended to mislead investors by artificially affecting market activity" and the rule is directed at misconduct that "deceives or defrauds" the market.[10]

The CFTC appears to have adopted the position that, whenever an entity with a large position trades large volumes to "defend" that position, it is employing a manipulative device in violation of Section 6(c)(1) and Rule 180.1.

Yet, in the JPMorgan Order, as Commissioner O'Malia suggested, the CFTC did not adhere to those limitations, and took a very broad, if not unprecedented, view that the buying of substantial volumes of a swap in a short period of time was a reckless use of a manipulative device because the size of the trades had the

6 *Id.*

7 75 Fed. Reg. at 67659 (emphasis added).

8 Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398, 41399 (CFTC July 14, 2011) (footnotes omitted).

9 *Id.* at 41401.

10 *See* 75 Fed. Reg. at 67658-59.

potential to affect market prices and because the volume of the trades was calculated to defend the position.[11] The CFTC observed:

> Such activity designed to 'defend' the position or 'fight' other market participants, whether through contemplated month-end trading or otherwise, falls squarely within the prohibitions of Section 6(c)(1) of the [CEA] and [CFTC] Regulation 180.1(a).[12]

In other words, the CFTC appears to have adopted the position that, whenever an entity with a large position trades large volumes to "defend" that position, it is employing a manipulative device in violation of Section 6(c)(1) and Rule 180.1. Yet, absent from the CFTC's findings and conclusions is a discussion as to whether there was an intent to mislead investors by artificially affecting market activity or whether the market was deceived.

The Courts' Interpretation of 'Manipulative and Deceptive Devices' Term

Despite the CFTC's declaration, the case law, including the decisions from the US Supreme Court, regarding manipulative and deceptive devices does not appear to support such a broad reading of Section 6(c)(1) of the CEA. Starting with the two seminal decisions from the US Supreme Court, to which the CFTC pointed in its releases, more is required.

In *Santa Fe*, the Supreme Court stated:

> 'Manipulation' is 'virtually a term of art when used in connection with securities markets.' The *term refers generally to practices*, such as wash sales, matched orders, or rigged prices, that are *intended to mislead investors by artificially affecting market activity*.[13]

In its decision issued one year earlier, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Supreme Court stated:

> Section 10(b) makes unlawful the use or employment of "any manipulative or deceptive device or contrivance" in contravention of Commission rules. The word "manipulative or deceptive" used in conjunction with "device or contrivance" *strongly suggests that § 10(b) was intended to proscribe knowing or intentional conduct*.[14]

The Supreme Court explicitly rejected the argument made by the SEC in its *amicus curiae* brief that the language was not limited to knowing or intentional practices, stating that:

> The [SEC's] argument simply ignores the use of the words "manipulative," "device," and "contrivance"—terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence. Use of the word "manipulative" is especially significant. It is and was virtually a term of art when used in connection with securities markets. *It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities*.[15]

11 JP Morgan Order, *supra* note 1, at 14-15.

12 *Id.* at 15.

13 430 U.S. 462, 475 (emphasis added; citations omitted).

14 425 U.S. 185, 197 (1976) (emphasis added; citations omitted).

15 *Id.* at 199 (emphasis added; footnotes omitted).

Three SEC enforcement cases underscore the burden of proof that an agency must meet. In all of them, there was a course of conduct intended to deceive the market.

In *Markowski v. SEC*, 274 F.3d 525 (D.C. Cir. 2001), the court sustained an enforcement proceeding determination that Michael J. Markowski had violated Section 10b-5 by engaging in manipulative, deceptive and fraudulent conduct. For a period of six months after an initial public offering, Markowski and his firm supported the price of the issuer's securities by maintaining high bid prices and absorbing all unwanted securities into inventory in order to prevent sales from depressing market prices. Markowski argued that there could not be a manipulation because the trades were real. The court acknowledged the difficulty that that situation creates, observing:

> It may be hard to separate a 'manipulative' investor from one who is simply overenthusiastic, a true believer in the object of investment. Both may amass huge inventories and place high bids, even though there are scant objective data supporting the implicit estimate of the stock's value. Legality would thus depend entirely on whether the investor's intent was 'an investment purpose' or solely to affect the price of the security.[16]

The court then concluded that it could not "find the [SEC's] interpretation to be unreasonable in light of what appears to be Congress's determination that 'manipulation' can be illegal solely because of the actor's purpose."[17]

In the *United States v. Mulheren* decision on which the D.C. Circuit relies, the US Court of Appeals for the Second Circuit reversed a criminal mail and wire fraud conviction predicated on violation of Rule 10b-5. The government based its criminal charge on the contention that, when an investor "engages in securities transactions in the open market with the sole intent to affect the price of the security, the transaction is manipulative and violates Rule 10b-5."[18] The Second Circuit observed that it had "misgivings" about the government's view of the law, but assumed without deciding on the appeal "that an investor may lawfully be convicted under Rule 10b-5 where the purpose of his transaction is solely to affect the price of the security."[19] In response to one of the government's arguments, the court stated:

> While we agree, as a general proposition, that market domination is a factor that supports a manipulation charge, the extent to which an investor controls or dominates the market at any given period of time cannot be viewed in a vacuum. For example, if only ten shares of stock are bought or sold in a given hour only by one investor, that investor has created 100 percent of the activity in that stock in that hour. This alone, however, does not make the investor a manipulator. The percent of domination must be viewed in light of the time period involved and other indicia of manipulation.[20]

16 274 F.3d 525, 528 (D.C. Cir. 2001) (quoting *United States v. Mulheren*, 938 F.2d 364, 368 (2d Cir. 1991)).

17 *Id.* at 529 (citations omitted).

18 938 F.2d at 368 (footnote omitted).

19 *Id.*

20 *Id.* at 371.

With respect to the decisions on which the government relied, the court stated that those instances involved the defendant exercising domination for a prolonged period of time (e.g., one year of engaging in more than 50 percent of the overall trading, and four months of accounting for approximately 29 percent of the daily volume). Consequently, the Second Circuit observed:

> When domination is sustained over such an extended period of time, evidence of manipulation is strong. But, if the percentage of control can be measured in terms of minutes or hours, anyone could find himself labeled as a manipulator.[21]

In *SEC v. U.S. Environmental, Inc.*, 155 F.3d 107 (2d Cir. 1998), the Second Circuit reversed the dismissal of the SEC's complaint brought by the SEC against a party participating in and assisting a manipulation. The SEC's complaint alleged that the manipulation consisted of a stock promoter, with the assistance of other parties, engaging in a course of conduct of effecting:

> (1) Offers, purchases, and sales of [the company's] securities in return for promises of risk-free profit for engaging in such trades;
> (2) Directed and controlled trades of [the company's] securities;
> (3) "Wash sales" and "matched orders"; and
> (4) Trades involving undisclosed nominees.[22]

The parties and their nominees traded the company's shares among themselves "'for the purpose of creating the appearance of an actual market for trading [the company's] shares' and thus raising [the company's] stock price."[23]

The difficulty of determining whether there has been a use of a manipulative or deceptive device when dealing with real as opposed to contrived trading (such as wash trades) is illustrated by decisions from the Northern District of Illinois and the Southern District of New York.

In *SEC v. Kimmes*, 799 F. Supp. 852 (N.D. Ill. 1992), the court held that the defendant had engaged in manipulation in violation of Section 10(b) and Rule 10b-5, and issued a permanent injunction. The legal predicate of the court's decision was:

> Securities manipulation, the final component or step of the scheme of [defendant] in his confederates, is conduct 'designed to deceive or defraud investors by controlling or artificially affecting the price of securities.' Among the fundamental purposes of the federal securities laws is the assurance of free and open securities markets in which prices are fixed by the interaction of supply and demand, uninfluenced by manipulative activities that would cause prices to be inflated or depressed artificially.
>
> That being so, any activities that falsely persuade the public that activity in an over-the-counter security is 'the reflection of a genuine demand instead of a mirage' are outlawed by 1933 Act § 17(a) and 1934 Act § 10(b). Such activities may include: (1) fraudulent promises of quick profits

21 *Id.*

22 155 F.3d 107, 109 (2d Cir. 1998).

23 *Id.*

> made by salesman to friends and customers; (2) directed and controlled trading in a security; (3) the use of wash sales and matched orders; (4) the use of undisclosed nominees; and (5) the use of material misrepresentations in newsletters and otherwise.[24]

The court held that the defendant had engaged in a series of "sham public offerings," the prices for which he artificially maintained by virtue of using captive brokerage companies, nominee accounts, false public filings and news releases, false price quotes and sham after-market transactions.[25]

In *SEC v. Masri*, 523 F. Supp. 2d 361 (S.D.N.Y. 2007), the court declined to grant the defendants' motion for summary judgment, after concluding (albeit reluctantly) that there were issues of fact requiring a trial. In doing so, the court held that:

> [T]he Court must decide the related question of whether an open-market transaction unaccompanied by deceptive or fraudulent conduct can support liability for market manipulation where the defendant has both a manipulative and nonmanipulative intent, whether it requires that the sole intent be to artificially affect the price of the stock, or whether some other standard is appropriate.
>
> The Court holds that in order to impose liability for an open market transaction, the SEC must prove that *but for* the manipulative intent, the defendant would not have conducted the transaction. The Court reaches this conclusion based on three considerations. First, in *Mulheren*, the Second Circuit accepted, with "misgivings," the government's theory that an open-market transaction could violate Section 10(b) where it was done with the "sole intent" to affect the price of securities, and not for any "investment purpose."
>
> Because the Second Circuit accepted the government's theory only with "misgivings," then *a fortiori*, it would find problematic a theory under which an investor could be found liable for market manipulation when only one of the investor's purposes was to alter the price. Second, if a transaction would have been conducted for investment purposes or other economic reasons, and regardless of the manipulative purpose, then it can no longer be said that it is "artificially" affecting the price of the security or injecting inaccurate information into the market, which is the principal concern about manipulative conduct.
>
> Finally, given the inherent ambiguity in determining intent, the concerns about imposing liability for otherwise legal activities based solely on intent, and the potential for chilling such legal activity, the Court finds it wise to err on the side of caution.[26]

The court concluded that there were factual issues regarding the SEC's claim and assertion regarding intent:

> [C]oncerned that his August 5 puts would expire "in the money," forcing him to purchase over 800,000 TZA shares, [the defendant] placed a large TZA order in the closing minutes on the day before expiration in

24 799 F. Supp. 852, 858-59 (N.D. Ill. 1992) (citations omitted).
25 *Id.* 857-59.

26 523 F. Supp. 2d 361, 372-73 (S.D.N.Y. 2007) (original emphasis; citations and footnote omitted).

order to artificially drive the price over $5 per share, thereby insuring that the options would expire worthless.[27]

Conclusion

The CFTC's position regarding trading intended to "defend" a position fails to take into account the case law addressing the meaning of a manipulative and deceptive device under the securities laws. Instead, the CFTC rests its view solely on the fact that any reasonable trader ought to know that such a volume of trades "may" affect prices. Yet, given the economics of a trading market, whether the market is liquid or illiquid, it is axiomatic that a large order to buy or sell a commodity or a swap may influence prices. That inherent possibility should not be enough to trigger liability. More is required, specifically, the intent to engage in conduct that is designed to deceive the market, and market deceit.

The CFTC's position regarding trading intended to "defend" a position fails to take into account the case law addressing the meaning of a manipulative and deceptive device under the securities laws.

Indeed, the factual context of the London Whale situation underscores the CFTC's overbroad interpretation of Section 6(c)(1). Throughout the fourth quarter of 2011 and the first quarter of 2012, there was substantial speculation in the industry regarding an extremely large swap position held by one trader, later learned to be JPMorgan, and some hedge funds began a concerted pattern of trading, taking substantial positions in the CDX swap in order to put pressure on prices and to obtain a profit at JPMorgan's expense.[28] Thus, when JPMorgan responded to the conduct of traders taking that counter-position, there was nothing deceptive or misleading about "defending" its position in a trading environment that consciously targeted JPMorgan's position. Indeed, if the decision to "defend" this position was enough to trigger liability under Section 6(c)(1), then logically the hedge funds that put on a position in order to attack the JPMorgan position could have likewise been exposed to the same charges.

All this goes to show that the CFTC's position is a dangerous and troubling one that triggers the very concerns expressed by the district court in *Masri*, namely, improperly chilling legitimate activity in the marketplace. In order to sustain enforcement claims under Section 6(c)(1) of the CEA, the CFTC should be required to demonstrate an actual intent to deceive or to cause artificial prices. Absent such boundaries, there will be unnecessary uncertainty and risk, and market participants will be denied the clear guidance to which they are entitled, just as Commissioner O'Malia feared in his dissent.

The CFTC's position is a dangerous and troubling one that triggers the very concerns expressed by the district court in *Masri*, namely, improperly chilling legitimate activity in the marketplace.

27 *Id.* at 373.

28 *See* Ahmed, Azam, "The Hunch, the Pounce and the Kill," *The New York Times*, May 26, 2012, at B1.

Any fund or trader that builds a large speculative position, whether or not in a very liquid market, must confront this risk. Likewise, this risk is present for large traders that are driven by technical market strategies. In essence, any such trader is at risk of being accused of trying wrongly to affect market prices by virtue of trading that is legitimately intended to protect or further a position's profitability. Unless the new leadership at the CFTC takes a more moderate view consistent with the long-standing legal development of the term "deceptive and manipulative conduct," large speculative traders, who are critical to ensuring that there is liquidity in the futures and derivatives markets, run the risk of enforcement action for pursuing historically acceptable trading practices, especially if their trading activity acquires any notoriety.

To protect against that risk, traders are confronted with several courses of action, none of which are ideal:

1. Do not change trading practices and be prepared to incur substantial legal expenses to defend against and oppose any enforcement activity by the CFTC and to oppose the CFTC's aggressive interpretation of the statutory provision.
2. Adopt substantial compliance systems to monitor the establishment and maintenance of large speculative positions and to vet trading strategies to protect those positions prior to the strategies being implemented.
3. Impose internal limits on the size of speculative positions, or prohibitions against such trading altogether, in order to prevent such positions from becoming sufficiently large to draw attention and ultimately to attract enforcement inquiries and/or actions.

These alternative courses of conduct compelled by the CFTC's position will lead to the very market-chilling effect that has concerned the courts. Absent self-reflection by the CFTC, either large speculative positions will be repressed for no legitimate reason or the cost of maintaining such positions will be substantially increased. In either circumstance, market liquidity, and thus price determination, will be unnecessarily damaged.

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