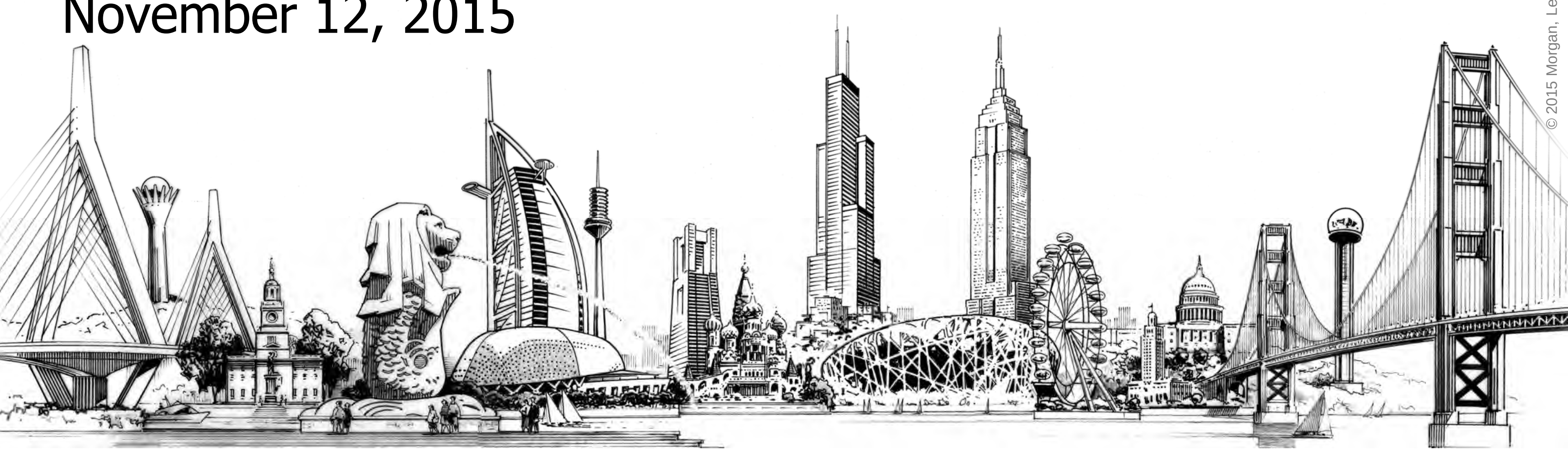
Morgan Lewis

Morgan Lewis Hedge Fund University™

UPDATE ON REGULATORY REFORM OF DERIVATIVES AND SHADOW BANKING:

RULEMAKING, MARKET TRENDS, AND THE POTENTIAL EFFECT ON HEDGE FUNDS

November 12, 2015



AGENDA

OTC Derivatives Reform. In the U.S., Title VII of Dodd-Frank created an entirely new regulatory scheme for OTC derivatives. This continues to roll out. Tom D'Ambrosio will talk about the latest developments in margin for noncleared swaps and Akshay Belani will give a brief update on the reporting for security-based swaps.

Margin Requirements for Non-derivatives. Not all instruments with delayed settlement are regulated as derivatives. Yet, the trend toward reducing systemic risk by imposing daily margining is being applied by regulators to these instruments. Akshay Belani will describe new margining in the TBA and MBA markets proposed by FINRA.

Trends in Clearing. Since 2008, global regulators and lawmakers have been modifying capital and other rules to reduce leverage and improve asset and liability management by big banks. While these developments affect banks directly, they are changing the market structure. We will discuss how these regulatory changes are driving a move to centralized clearing for repos and sec lending, and reduction in the number of FCMs for swaps and raising the question of self-clearing by the buy side.

Update on the Stay Protocol. After the crisis, global regulators have created special resolution regimes for the largest banks. We will update you briefly on the current status of the ISDA Stay Protocol and what it means for the buy side.

Tax. Of course, while these tectonic changes are going on, the tax authorities are not sleeping. Chuck Bogle will speak briefly about recent tax developments affecting derivatives.

SECTION 01

OTC DERIVATIVES REFORM: NEW MARGIN RULES FOR UNCLEARED DERIVATIVES

The Times They Are a-Changin'

- Pre Dodd-Frank:
  - Margin set by contract
- Post Dodd-Frank:
  - Margin for cleared swaps/security-based swaps (SBS) set by the clearinghouse and the FCM
  - Uncleared swaps (5+ years in the making)
    - Statutory standard from 2010
      - Prudential regulators (for dealers and majors that are banks) and the CFTC and SEC (for other dealers and majors) were given the mandate to impose both initial and variation margin on uncleared swaps
      - Margin requirements should be imposed to help ensure the safety and soundness of the dealer or major and be appropriate for the risk associated with uncleared swaps
        - Uncleared swaps seen as creating greater risk to the dealers and majors and the financial system in general

Final Margin Rules

- Adopted by prudential regulators October 30, 2015
  - Prudential regulators:
    - Office of the Comptroller of the Currency
    - Board of Governors of the Federal Reserve System
    - Federal Deposit Insurance Corporation
    - Farm Credit Administration
    - Federal Housing Finance Agency

- Prudential regulators consulted with CFTC and SEC in developing the final rules (as required by Dodd-Frank)

Interim Final Rule

- Interim Final Rule also adopted October 30, 2015
  - Margin rules do not apply to an uncleared swap if the counterparty
    - Qualifies for the commercial end-user exception to clearing
    - Qualifies for an exemption from clearing pursuant to CFTC rule or order concerning cooperative entities
    - If an affiliate, satisfies the clearing exception for affiliates

CSEs

- Margin rules apply to covered swap entities (CSE)
  - A CSE is a swap dealer, MSP, security-based swap dealer and MSBSP that is subject to regulation by a prudential regulator

Initial Margin (IM)

- CSEs must **collect** IM from
  - Swap entities (dealers or majors)
  - Financial end user (FEU) with material swaps exposure
    - HEDGE FUNDS ARE FEUs AND SOME WILL HAVE MATERIAL SWAPS EXPOSURE
    - Material swaps exposure means that entity and affiliates have average daily (business days only) aggregate notional amount of uncleared swaps, FX forwards and FX swaps with all counterparties for June, July and August of prior year that exceeds $8 billion
      - Swaps not double counted
      - Swaps exempt from clearing not counted
- CSEs must **post** IM to
  - Financial end user (FEU) with material swaps exposure
  - CSEs will already be required to collect

Initial Margin (IM)

- CSEs must **collect** IM from counterparties that are not SEs or FEU with material swaps exposure at such times and in such forms and such amounts that the CSE determines appropriately address the credit risk posed by the counterparty and the uncleared swap.
  - MOST HEDGE FUNDS WILL FALL WITHIN THIS CATEGORY

- CSEs not required to **collect or post** IM for uncleared trades exempt from clearing requirement.

Financial End User

- A FEU is anyone that is not a swap entity but is
  - bank holding company (or affiliate), S&L holding company, U.S. intermediate holding company, nonbank financial institution supervised by Fed
  - depositary institution, foreign bank, credit union, trust company, industrial loan company, industrial bank
  - state licensed credit or lending entity, finance company, money lender, installment lender, consumer lender, mortgage lender, broker, bank, motor vehicle title pledge lender, payday or deferred deposit lender, premium finance company, commercial finance company, commercial mortgage company, money services business, check casher, money transmitter, currency dealer, money order or traveler's check issuer
  - an entity regulated by the Federal Housing Finance Agency or Farm Credit Administration

Financial End User

- a securities holding company, broker or dealer, investment adviser, investment company, BDC
- private fund (3(c)(1) and 3(c)(7) funds) or one of certain exempt investment companies
- commodity pool, CPO, CTA, floor broker, floor trader, introducing broker, FCM
- employee benefit plan (including a governmental plan)
- insurance company, reinsurance company
- entity that raises money from investors or clients or uses its own money to invest or trade in loans, securities, swaps, funds or other assets
- entity that would be an FEU if it were organized in the U.S.

• FEU does not include:
  - a sovereign entity (central government, agency, department, ministry of a central government), multilateral development bank, BIS, finance subsidiaries, affiliates exempt from clearing requirement

Initial Margin Amount and Timing

- Amount of IM that CSE must **collect** cannot be less than the greater of zero or
  - Initial margin collection amount **less** initial margin threshold amount
    - Initial margin collection amount is set forth in the rule or, if the CSE uses an initial margin model (internal risk management model) approved by the regulator, the amount called for by that model
    - Initial margin threshold amount is an aggregate credit exposure of $50 million resulting from uncleared swaps between the CSE and its affiliates and a counterparty and its affiliates
- Amount of IM that CSE must **post** must be as large as the amount that the CSE would be required to collect if it were the counterparty.
- IM must be collected/posted on T+1 and maintained until termination of swap

Initial Margin Standard Table

Asset Class	Gross Initial Margin (% of Notional Exposure)
Credit: 0-2 year duration	2
Credit: 2-5 year duration	5
Credit: 5+ year duration	10
Commodity	15
Equity	15
Foreign Exchange/Currency	6
Cross Currency Swaps: 0-2 year duration	1
Cross-Currency Swaps: 2-5 year duration	2
Cross-Currency Swaps: 5+ year duration	4
Interest Rate: 0-2 year duration	1
Interest Rate: 2-5 year duration	2
Interest Rate: 5+ year duration	4
Other	15

Variation Margin

- CSEs must **collect** and **post** VM from/to SEs and FEUs
  - VM is based on change in value since the last time VM was transferred
  - VM required on each business day from T+1 until termination of swap
  - HEDGE FUNDS WILL BE IN THIS CATEGORY

- CSEs must **collect** VM from counterparties that are neither SEs or FEUs at such times and in such forms or amounts that the CSE determines appropriately address the risk posed by the counterparty and the risks of the swap
- CSEs are not required to **collect** or **post** VM on swaps exempt from clearing
- MTA of $500,000 for IM and VM

Netting

- IM, IM modeling and VM can be based on an aggregate net basis for all uncleared swaps
  - Swaps must be subject to an eligible master netting agreement
    - Must be written and legally enforceable
    - Must create a single obligation
    - Must provide for termination/acceleration upon default (without stay or avoidance, other than stays under banking laws and Dodd-Frank)
    - Must not contain any walkaway clause
    - Must conduct a legal review and have a well-founded basis for netting position (otherwise must analyze on a gross basis)
    - Must establish and maintain written procedures to monitor possible changes in relevant law
  - Swaps entered into pre-compliance date but under the eligile master netting agreement will become subject to margin rules
  - Master agreement may identify separate portfolios for netting purposes

Eligible Collateral

- For swaps between CSE and SE collection of VM must be in cash (USD, major currency or currency of settlement) and IM must be in cash or listed collateral
  - Major currency: Canada, Euro, United Kingdom, Japan, Switzerland, New Zealand, Australian, Sweden, Denmark, Norway
  - Listed collateral for IM only:
    - U.S. Treasuries; U.S. Agencies; ECB securities; sovereigns having no higher than a 20% risk weight under capital rules, publicly traded GSE securities, securities of BIS or IMF or multilateral development bank, certain publicly traded debt (not asset backed), publicly traded common equity in S&P 1500 Index or similar index, redeemable securities in pooled fund if the fund investments are limited to U.S. Treasuries, ECB securities or sovereigns having no higher than a 20% risk weight gold
  - Not eligible collateral: securities of affiliates, banking entities or their affiliates, market intermediaries, nonbank financial institutions supervised by Fed

Eligible Collateral

- For swaps between CSE and FEU, CSE must **collect and post** IM and VM in cash (USD, major currency or currency of settlement) or listed collateral
  - HEDGE FUNDS ARE IN THIS CATEGORY
- Eligible Collateral is subject to discount
  - 8% discount for VM denominated in a currency that is not USD, major currency or the settlement currency
  - 8% discount for IM denominated in a currency that is not the settlement currency, except for IM denominated in the termination currency of an eligible master agreement
  - Other discounts pursuant to rule

Eligible Collateral Discounts

Asset Class	Discount (%)
Eligible government and related (e.g., central bank, multilateral development bank, certain GSE securities supported by U.S.) debt: residual maturity less than one year	0.5
Eligible government and related (e.g., central bank, multilateral development bank, certain GSE securities supported by U.S.) debt: residual maturity between one and five years	2.0
Eligible government and related (e.g., central bank, multilateral development bank, certain GSE securities supported by U.S.) debt: residual maturity greater than five years	4.0
Certain other eligible GSE debt securities: residual maturity less than 1 year	1.0
Certain other eligible GSE debt securities: residual maturity between 1 and five years	4.0
Certain other eligible GSE debt securities: residual maturity greater than five years	8.0
Other eligible publicly traded debt: residual maturity less than 1 year	1.0
Other eligible publicly traded debt: residual maturity between 1 and five years	4.0
Other eligible publicly traded debt: residual maturity greater than five years	8.0
Equities included in S&P 500 or related index	15.0
Equities included in S&P 1500 Composite or related index but not S&P 500 or related index	25.0
Gold	15.0

Segregation

- IM posted by CSE must be held at a custodian that is not affiliated with CSE or counterparty
- IM collected by CSE must be held at a custodian that is not affiliated with CSE or counterparty
- Custodian must act pursuant to a legally enforceable (including in bankruptcy) written agreement that prohibits rehypothecation of assets
  - Cash can be held in a general deposit account temporarily if used to purchase assets
  - Posting party may substitute collateral or direct reinvestment of collateral

Cross-Border

- Margin rules do not apply to swaps between a foreign CSE (a CSE not organized under U.S. law or a branch or subsidiary of such entity) and a foreign person (not organized under U.S. law, not a U.S. resident, not a branch of a U.S. entity, not an SE subsidiary of a U.S. entity)

- Possibility of substituted compliance in certain circumstances

Documentation

- More changes coming
  - Documents must specify methods, procedures, rules and inputs for determining value, IM and VM
- Look for more protocols as compliance dates arrive

Compliance Dates

- September 1, 2016
  - For IM and VM where both CSE + affiliates AND counterparty + affiliates have average daily (business days only) aggregate notional amount in uncleared swaps, FX forwards and FX swaps for the prior March, April and May (ADANA) exceeding $3 trillion
- March 1, 2017 (Almost 7 years later!)
  - For VM for all CSEs and counterparties
- September 1, 2017
  - For IM where both CSE + affiliates AND counterparty + affiliates have ADNA exceeding $2.25 trillion
- September 1, 2018
  - For IM where both CSE + affiliates AND counterparty + affiliates have ADNA exceeding $1.5 trillion
- September 1, 2019
  - For IM where both CSE + affiliates AND counterparty + affiliates have ADNA exceeding $0.75 trillion
- September 1, 2020 (10+ years later!)
  - For IM for all CSEs and counterparties

SECTION 02

SECURITY-BASED SWAP REPORTING

Regulation SBSR

- Final rule adopted February 11, 2015; effective May 18, 2015
  - Applies to all SBS entered into or guaranteed by an SBSD, MSBSP or US Person (including foreign branches), or SBS cleared by a US clearing agency
    - Includes SBS resulting from allocation, termination, novation or assignment of another SBS
- Interim reporting deadline for reporting SBS to an SBSDR= T+24 hours (or at the same time on the next business day)
  - Embargo rule: restricts dissemination of SBS data by parties prior to Primary Trade Information being sent to a registered SBSDR
  - SB SEF cannot broadcast SBS trades on its platform until reporting is initiated
- Includes the following proposed amendments for public comment
  - duties of certain reporting parties and SBSDRs
  - proposed interim schedule requiring:
    - Reporting within six months after registration of first SBSDR that accepts data in a particular asset class (includes historical swap reporting)
    - Public dissemination three months after reporting is required

Who Must Report?

- The "reporting side" of the transaction is responsible to report the transaction to an SBSDR or, if no SBSDR is available that will accept the reportable information, to the SEC.
  - Defines a "side" to include the direct counterparty to the SBS and any guarantor of the direct counterparty's obligations
  - Reporting sides may utilize third party agents to report on their behalf
- If only one side includes a "registered person" (SBSD/SBMSP), that side must report
- Parties must select the reporting side if:
  - both sides include a registered person
  - neither side includes a registered person and both sides include a U.S. person
- What scenarios are not covered? SEC will propose additional rules regarding the following:
  - (i) No registered person; only one side is a U.S. person
  - (ii) No registered person; accepted for clearing in U.S.; no U.S. person

Who Must Report?

- Proposed Rules:
  - Clearing agency must report a "clearing transaction"
    - Parties to SBS must also report and indicate SBS is intended to be cleared
  - SB SEF must report on-facility transactions
  - Unlike CFTC rules, one side to an on-facility, uncleared SBS must still report

What Must Be Reported?

- Requires "primary trade information" to be reported
  - Reg SBSR prescribes minimum categories of SBS information
  - SBSDRs required to prescribe specific data elements of an SBS that must be reported
- "Condition flags" must be reported by SBSDR in its "fair and reasonable estimation" including among others:
  - inter-dealer flag
  - to-be-cleared flag
  - bespoke transaction flag
  - package transaction flag
  - transactions resulting from netting/compression exercises
  - any other flags required under the policies and procedures of the SBSDR to which the transaction is reported
- Historical SBS (includes preenactment and transitional SBS) for a particular asset class must be reported within six months after an SBSDR has commenced operations for that asset class
- Historical SBS still in existence would be subject to life cycle event reporting
- No public dissemination of historical SBS data is required

SECTION 03

PROPOSED MARGIN FOR TO-BE-ANNOUNCED SECURITIES

FINRA Rule 4210

- FINRA submitted the proposed rule to the SEC for approval on 10/6/15
  - Public comment period expired 11/10/15
- Based on TMPG best practices for Treasury, Agency, Debt, and Agency MBS Markets from April 2014
- Purpose is to mitigate credit risk to FINRA member firms
- Requires that FINRA member firms <u>collect</u> maintenance margin and variation margin in respect of Covered Agency Transactions
  - Covered Agency Transactions:
    - TBA transactions (including ARM transactions) and Specified Pool Transactions where settlement is greater than one business day after trade date
    - Certain CMO transactions where settlement is greater than three business days after trade date
- Maintenance margin requirement = 2% of the contract value of net long or net short position, by CUSIP, with the counterparty
- No specific compliance timeline set out in rule but if approved by SEC then could become effective within 240 days of approval.

FINRA Rule 4210

- Under the proposed rule, FINRA members are:
  - required to deduct the amount of any uncollected mark-to-market loss in calculating its net capital pursuant to SEA Rule 15c3-1 at the end of the day following the business day of creation of a deficiency
  - required to take liquidating action if a margin deficiency is not cured within five business days (unless granted an extension by FINRA)
- Margin must be posted same day to avoid capital charges to members
- Margin transfer is subject to a minimum transfer amount of $250,000

Exemptions from Margin Requirements

- Members can <u>elect</u> to not apply margin requirements to:
  - federal banking agencies, central banks, foreign sovereigns, multilateral development banks and BIS
  - Member must make a written risk limit determination for each such party
  - Note: no exemption for sovereign wealth funds
- Exemption from margin requirements for:
  - Covered Agency Transactions cleared through a registered clearing agency
  - Counterparties with gross open positions in Covered Agency Transactions with the member of $2.5M or less where contractual settlement is within two months of trade date and customer regularly settles its Covered Agency Transactions on a DVP basis or for cash.
    - Exemption does not apply to a counterparty that engages in dollar rolls, round robin trades or other financing techniques for its Covered Agency Transactions

Exemptions from Margin Requirements

- Exemption from maintenance margin requirement for Covered Agency Transactions where contractual settlement is within two months of trade date and customer regularly settles its Covered Agency Transactions on a DVP basis or for cash.
  - Exemption does not apply to a counterparty that engages in dollar rolls, round robin trades or other financing techniques for its Covered Agency Transactions
- Exempt Accounts are exempt from maintenance margin requirement but not variation margin.
  - Include broker-dealers, "designated accounts" high-net-worth persons
    - High net worth persons/accounts: net worth of at least $45M and financial assets of at least $40M
    - Does not include regulated foreign institutions or collective investment trusts
    - Does not include collective investment trusts comprised of exempt accounts

Potential Issues with Rule 4210

- Maintenance margin requirement will have a limited impact on reduction of systemic risk
- Does not mandate bilateral variation margin
- Mandating liquidating action after 5 days inhibits ability to bring legitimate disputes regarding market value of positions and collateral
- Same day margin transfer timing is not operationally feasible for many market participants
  - Also does not work for transactions with non-US accounts or non-US dollar denominated transactions where currency conversion is required.

SECTION 04

TRENDS IN CENTRAL COUNTERPARTY CLEARING OF SWAPS, REPO, AND SEC LENDING

TRENDS: Clearing of Repo and Sec Lending

Development of Buy-side CCP Clearing for Repo and Sec Lending

- Press reports that LCH.Clearnet, CME Group, DTCC and Eurex are working toward offering buy-side repo clearing in the U.S.
- Press reports that Eurex working on sec lending clearing in the U.S.
- As described below, this is largely driven by pressure on banks arising from regulation on leverage and liquidity
- Will create shift in market from bilateral to cleared environment

Potential Impact on Buy-side

- Potential increased costs
- Need for access to clearing house (clearing members?)
- Changes in margin regime
- Changes in forms of custody
- New documentation negotiation

TRENDS: Fewer FCMs for Swap Clearing

FCMs Exiting Marketplace

- Over last 2 years, there have been departures from OTC swap clearing of five major FCMs.
- Of remaining 12 FCMs that offer OTC derivatives clearing, 75% of the total client collateral is held by the leading 6 FCMs.
- FCM focus on the most profitable clients with assurances of activity.
- Concerns about costs being passed down to end users through a basis point fee on margin, minimum floor on activity or similar methods.

TRENDS: Self-Clearing by Buy-Side?

What is self-clearing? Buy side clears transactions directly with the clearing house, without FCM.

What is needed to be a clearing member? Generally:

- maintain a minimum capital (at least $5-50 million);
- make a contribution to the default fund (usually several million dollars);
- demonstrate risk management and operational capabilities sufficient to carry out swaps clearing;
- demonstrate ability to calculate and disseminate end-of-day settlement prices and participate in DCO default management where another clearing member has defaulted; and
- be subject to regulation by a competent regulatory authority.

Has anyone done this?

- On 10/20/15, Citadel Securities (Europe) Limited announced it had become the first non-bank clearing member of LCH.Clearnet's Swap Clear.

What Is Driving These Trends?

Basel III type changes incentivize banks to:

- **Reduce reliance on short-term wholesale funding** --
  - **Liquidity Coverage Ratio**: Banks are required to hold sufficient high quality liquid assets (HQLA) to cover a stress scenario of net cash outflows over a 30-day period
  - **Net Stable Funding Ratio**: ratio of Available Stable Funding to Required Stable Funding
    - Available Stable Funding (ASF): capital and liabilities expected to be reliable over time horizon of 1 year
    - Required Stable Funding (RSF): weighted sum of value of assets held and funded including off-balance sheet exposures where weights are assigned to each RSF asset category. Higher weighting for illiquid assets
- **Prioritize use of balance sheet to more profitable businesses**
  - **Increased minimum capital requirements and capital buffers**
- **Reduce leverage**
  - **Supplemental Leverage Ratio (SLR)**.

EXAMPLE: The SLR and Repo Clearing

Summary of the SLR

- Adopted by U.S. banking regulators in July 2013 as part of revised capital rules.
- Minimum SLR of 3% for all "advanced approaches banking organizations" and additional 2% leverage buffer for top-tier holding companies with more than $700 billion in consolidated total assets or more than $10 trillion in assets under custody.
- Test is: $\frac{Tier\ 1\ Capital}{Total\ Leverage\ Exposure}$
- "Total Leverage Exposure" is calculated as (i) the mean of the on-balance sheet assets calculated as of each day of the reporting quarter, *plus* (ii) the mean of the off-balance sheet assets calculated as of the last day of each of the most recent three months, *minus* (iii) the applicable deductions under the Revised Capital Rules.

EXAMPLE: The SLR and Repo Clearing (continued)

Total Leverage Exposure

Total Leverage Exposure (i.e. the denominator) includes:

- **Derivatives Exposure:**
  - must include carrying value of on balance sheet derivatives
  - may recognize cash variation margin if:
    - cash not segregated;
    - daily m-t-m;
    - covers full amount of exposure (subject to MTA and threshold);
    - same currency as settlement currency; and
    - subject to netting agreement.
- **Repo-style Transactions:** May do GAAP offset (offset gross values of receivables under reverse repo by payments due on repos) so long as:
  - same counterparty;
  - right to offset enforceable in normal course and in insolvency;
  - same settlement date, and;
  - intent to settle simultaneously.

EXAMPLE: The SLR and Repo Clearing (continued)

- **CCP Clearing of Repo as Possible Solution**
  - Banks will have limitations on ability to do bilateral repo because the exposure with its various counterparties is not nettable.
  - Central counterparty clearing for repo provides a potential solution since in most cleared environments, the bank will only face a single counterparty and will enter into standardized, nettable repurchase agreements.

SECTION 05

UPDATE ON ISDA STAY PROTOCOL

BACKGROUND: Special Resolution Regimes

- **Special Resolution Regimes (SRRs):** Expansive resolution powers in insolvency or failure of SIFI focusing on recapitalization and preserving the failing institution or viable parts of it as a going concern.
- **"Single Point of Entry":** Put into insolvency proceedings only the top entity in a bank group, imposing the losses on the equity holders and unsecured creditors of this top entity, allowing viable subsidiaries to continue to operate. Avoids Lehman-like cascading of insolvencies.
- **Liquidation/Closeout of Protected Contracts:** Under standard market documentation for financial contracts, contractual acceleration, termination and other close-out rights triggered by resolution of counterparty or specified affiliates. Regulatory concern with "race to exits."
- **SRR Override:** Counterparties should not be able to exercise termination rights on entry into resolution if payment, delivery and collateral obligations are being met.
- **SRR Temporary Stay:** If termination rights are nevertheless exercisable, should be temporary stay of such rights if payment, delivery and collateral obligations are being met.

BACKGROUND: 2014 Stay Protocol

- **2014 Stay Protocol**: In November 2014, G-18 banks adhered to the ISDA Stay Protocol, a contractual agreement among adherents to fill in gaps in the global SRRs. The 2024 Protocol has 2 sections.
  - **Section 1:** Adhering cross-border counterparties agree to be bound by the provisions of a foreign SRR, even if the choice of law would not clearly apply to the foreign SRR. Effective January 2015.
  - **Section 2:** Would contractually limit use of certain cross-default rights in the case of a counterparty's affiliate's bankruptcy (despite safe harbors under the U.S. Bankruptcy Code) so long as no performance default. Not effective until further regulations are promulgated by the Federal Reserve and other U.S. regulators.

RECENT DEVELOPMENTS: 2015 UDP

- **2015 Universal Dealer Protocol (UDP)**. The 2014 Stay Protocol has been amended by ISDA working with a broad working group including representatives from sell side, buy side, and large collection of trade associations.
  - **Now Includes Securities Finance Transactions**. Previously only included ISDA Master Agreements. In May 2015, the PRA issued a consultation paper, "*Contractual Stays in Financial Contracts Governed by Third-Country Law*" covering derivatives, repo and reverse repo and securities lending transactions governed by the laws of jurisdictions outside the European economic area. In response, trade associations created SFT Annex to cover these transactions.
  - **Launch**. Anticipated by regulators that by the G-20 Summit (next week), G-18 and certain G-SIBs will have adhered.
  - **Is Buy-side Expected to Adhere?** In last minute scramble, ISDA decided that it could not limit adherence only to G18 or G-SIBs; now any party may adhere. Be on the lookout.

ON THE HORIZON: Modular Protocol

- **2016 Laws/Regulations**: Regulators in 6 jurisdictions (i.e., France, Germany, Japan, Switzerland, the U.K. and the U.S.) will finalize laws/regulations by the end of 2015 or early 2016 effectively requiring counterparties that face their regulated institutions to contractually recognize potential stays.
- **Modular Protocol**: In 2016, as regulations are finalized, ISDA will finalize a modular version of the Stay Protocol to help market participants achieve compliance with these laws and regulations.
  - **Still in Development**: A number of open issues about the modular protocol including "all-to-all" vs. "matching" and "retroactivity"
  - **Will Apply to Buy-Side**: Expectation that regulations will require buy-side compliance

SECTION 06

US TAX DEVELOPMENTS AFFECTING DERIVATIVES

"Dividend Equivalent" Rules Finalized

- General Tax Treatment
  - Dividends paid by U.S. corporations to non-U.S. shareholders generally are subject to 30% gross-basis withholding.
  - Payments on "notional principal contracts" – broadly defined to include most swaps – generally are not subject to withholding.
    - Technically, swap payments are sourced to the residence of the payee, and so are foreign-source when paid to non-U.S. counterparties.
  - Many non-U.S. counterparties therefore invested in U.S. equities through total return or other equity swaps, and could receive payments related to dividends free of withholding.
- Legislative Response
  - Section 871(m), enacted in 2010 as part of HIRE Act.
  - Provided that "dividend equivalent" payments on "specified" notional principal contracts" would be treated as a U.S.-source dividend, subject to withholding.

"Dividend Equivalent" Rules Finalized (cont.)

- Legislative Response (cont.)
  - "Dividend equivalent" payments include:
    - any substitute dividend made pursuant to securities lending or sale-repurchase transaction, or any payment on a "specified notional principal contract" that is contingent on, or determined with reference to, payment of dividend by U.S. corporation. Can apply even if no actual payment is made.
  - Four types of swaps singled out as "specified notional principal contracts":
    - the non-U.S. person, in connection with entering into the swap, transfers the underlying security to the short party (i.e., "crosses in");
    - the short party, in connection with closing or terminating the swap, transfers the underlying security to the non-U.S. person (i.e., "crosses out");
    - the underlying security is not publicly-traded; or
    - the short party posts the underlying security to the non-US person as collateral.
  - Additional contracts can be identified in regulations.

"Dividend Equivalent" Rules Finalized (cont.)

- Regulatory Response
  - IRS has struggled to implement these rules. Initial regulations proposed in January 2012 to expand scope of "specified notional principal contracts" subject to criticism and pulled in August 2012.
  - Temporary and proposed regulations issued in 2013 applied four statutory definitions of "specified notional principal contracts" to payments made before January 1, 2016, at which time new rules in reproposed regulations would apply.
  - Temporary and final rules issued in September, 2015.
    - Four statutory categories of "specified notional principal contracts" will apply to all swaps and other equity-linked instruments ("ELIs") issued prior to 2016.
    - Swaps and ELIs issued *during 2016* will not be subject to new rules (and so will be tested only under four statutory categories) until January 1, 2018.
    - Swaps and ELIs issued on or after January 1, 2017 are tested under new rules.

"Dividend Equivalent" Rules Finalized (cont.)

- Final Regulations Applicable to Instruments Issued in 2017 and After
  - Rules apply to several types of contracts:
    - Securities lending and sale-repurchase transactions;
    - "Specified" ELIs; and
    - "Specified" "notional principal contracts."
  - An ELI is a financial transaction that references one or more dividend-paying U.S. securities or a convertible or equity-linked debt instrument.
    - Examples of such transactions include futures contracts, forward contracts, options and debt instruments.
  - A "notional principal contract" is defined as:
    - a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts; and
    - references a dividend-paying U.S. stock or an equity-linked or convertible debt instrument.

"Dividend Equivalent" Rules Finalized (cont.)

- Final Regulations Applicable to Instruments Issued in 2017 and After (Cont.)
  - Exempt Contracts/Payments
    - Payment references a distribution on a U.S. security that would not be subject to withholding if paid directly to a non-U.S. person, i.e., capital gain distribution by mutual fund;
    - Payments made with respect to a "qualified index."
      - Meets the following requirements as of first day of calendar year that transaction opened:
        - References 25 or more component securities;
        - 95% or more of the value of the index is attributable to long positions in component securities;
        - contains no component security that represents more than 15 percent of the weighting of the underlying securities in the index;
        - does not reference five or fewer components that together represent more than 40 percent of the weighting of the component securities;
        - modified or rebalanced only according to publicly stated, predefined criteria (which may require interpretation by the index provider or a board);
        - does not provide a dividend yield in the immediately preceding year that is greater than 1.5 times the dividend yield of the S&P 500 Index for the preceding year; and
        - futures contracts or option contracts on the index traded on public exchange or a domestic board of trade designated as a contract market by the CFTC, or on a foreign exchange that the IRS has designated as a qualifying board of exchange for the mark-to-market rules of code Section 1256 and U.S. securities constitute less than 50 percent of the weighting of the components.
      - Rules regarding rebalancing changed so that subjective criteria may be used – "qualified index" now includes most standard indexes, S&P, etc.

"Dividend Equivalent" Rules Finalized (cont.)

- Final Regulations Applicable to Instruments Issued in 2017 and After (cont.)
  - Exempt Contracts/Payments (cont.)
    - Payment referencing a payment on a partnership interest, so long as the partnership is not a dealer or trader in securities and does not hold significant investments in securities.
    - Deemed dividends arising from adjustments made on convertible debt and other equity-linked instruments.
    - Certain due bill transactions where a seller of stock agrees to deliver the amount of a pending U.S. dividend after the record date to the stock purchaser.
    - Payments made by non-U.S. insurance companies.
    - Dividends paid on unvested stock granted to a non-U.S. person as compensation.
    - Payments arising in merger arbitrage transactions that reference dividends paid pursuant to a plan on the part of one or more persons to acquire more than 50 percent of the outstanding stock of a corporation.

"Dividend Equivalent" Rules Finalized (cont.)

- Final Regulations Applicable to Instruments Issued in 2017 and After (Cont.)
  - Rules Applicable to Nonexempt Contracts
    - Simple Contracts: all amounts paid on the contract are determined with reference to a single, fixed number of shares of the underlying security, provided that the number of shares can be ascertained when the contract is issued; and the contract has a single maturity or exercise date with respect to which all amounts are required to be calculated with respect to the reference security, even if that date can be accelerated.
      - If the amount paid or received is discontinuously increased or decreased, the contract is not a simple contract.
    - Simple contracts are 871(m) transactions if the delta (the relationship of the change in fair market value of the swap or ELI to a small change (generally less than 1 percent) in the fair market value of a referenced security) determined only on date contract is issued, is greater than or equal to 0.8
    - Delta increased from 0.7 in proposed regulations. No retesting required.

"Dividend Equivalent" Rules Finalized (cont.)

- Final Regulations Applicable to Instruments Issued in 2017 and After (Cont.)
  - Rules Applicable to Nonexempt Contracts (cont.)
    - Complex Contracts: Any swap or ELI that is not a simple contract.
      - The regulations contain two examples of complex contracts—a digital option that provides a single payout (or terminates) when a target price is reached and a swap in which the long party receives the return on 200 shares of a stock, but bears losses on only 100 shares of the same stock.
    - If an ELI or a swap is a complex contract, payments on the contract are dividend equivalents if the contract satisfies the "substantial equivalence test," which "assesses whether a complex contract substantially replicates the economic performance of the under security by comparing, at various testing prices, the differences between expected changes in value of a 'simple contract benchmark' and its initial hedge."
    - A simple contract benchmark is a simple contract (as defined above), with a delta of at least 0.80, referencing the underlying security and that has substantially the same terms as the instrument being tested. The simple contract benchmark can be a call option, put option or collar transaction.
    - The substantial equivalence test is met if the expected change in value of the complex contract and its initial hedge is equal to or less than the expected change of the simple contract benchmark and its initial hedge, determined as of the time at which the contract was issued.

"Dividend Equivalent" Rules Finalized (cont.)

- Industry Response
  - Short-Form Hire Act Protocol, published in 2010, has become standard in most equity-linked swap contracts.
    - Essentially provides that any tax required to be withheld under 871(m) provisions will not be an "indemnifiable tax" that payor is required to gross up.
    - Also includes representations designed to assure parties that contract is not within the four statutory categories of a "specified notional principal contract."
  - ISDA published new 2015 Section 871(m) Protocol on November 2, 2015.
    - If entered into, will replace 2010 protocol language in any pre-2017 master agreement for any swap entered into on or after January 1, 2017 under that agreement.
    - If prior agreements do not include 2010 protocol language, new language will apply to any transaction under that agreement entered into, or modified on or after January 1, 2016.
    - Essentially provides that tax under 871(m) is not indemnifiable tax, and provides that payee will indemnify payor if tax is imposed on payor.

IRS Issues Non-periodic Payment Guidance

- General
  - Many swaps contain significant upfront payments, followed by periodic payments from recipient of initial payment to counterparty.
  - IRS concerned that these transactions may appear more similar to loans, and periodic payments appear similar to interest. If periodic payor is U.S. person and counterparty is non-U.S., arguably some periodic payments should be treated as interest and subject to withholding.
- Prior Rules
  - An NPC with "significant" nonperiodic payments is generally treated as two separate transactions consisting of an on-market, level-payment swap, and a loan. Under this embedded loan rule, the loan is required to be accounted for by the parties to the contract separately from the swap and the time-value component associated with the loan is recognized as interest for tax purposes.

IRS Issues Non-periodic Payment Guidance (cont.)

- New Rules
  - On May 8, 2015, IRS published temporary rules clarifying and expanding the scope of swaps that would be treated as having embedded loans.
  - For NPCs entered into on or after the later of January 1, 2017, or six months after the publication date of the final regulations, the embedded loan rule applies if an NPC has *any* type of nonperiodic payment, whether significant or non-significant.
  - However, for NPCs entered into on or after May 8, 2015, there are two exceptions:
    - the term of the contract is one year or less; or
    - the nonperiodic payments meet prescribed margin or collateral requirements, specifically, either:
      - contract is cleared derivative and clearing organization or agency requires parties to post and collect margin or collateral to fully collateralize the mark-to-market exposure on the contract on a daily basis for the entire term – generally, contract is subject to both initial variation margin in an amount equal to the nonperiodic payment and daily variation margin in an amount equal to the daily change in the fair market value of the contract; or
      - the parties to the contract are required, pursuant to the terms of the contract or the requirements of a federal regulator, to post and collect margin or collateral to fully collateralize the contract.

Other Tax Issues for Hedge Funds and Managers

- "Carried Interest" legislation
  - Frequently proposed and reproposed.
  - Depending on form, could convert a portion of "carry" from capital gain to ordinary income.
  - Probably less significant for hedge fund managers than for private equity.
- Partnership Audit Rule Changes
  - Passed as part of two-year budget deal on November 2, 2015
  - Eliminates the ability of partners to participate in partnership examinations and empowers a sole partnership representative (who need not be a partner) to control partnership examinations and bind all partners.
  - Makes the partnership directly liable for any deficiencies, but provides two mechanisms whereby the partnership can shift part or all of any deficiency obligation to the persons who were partners in the partnership in the year under examination.
  - Applies to all partnerships that have more than 100 partners or that have a direct partner that is classified as a partnership for federal tax purposes. Other partnerships may elect out of the new regime.

Bio

Akshay N. Belani
akshay.belani@morganlewis.com
101 Park Ave.
New York, NY 10178
United States
T +1.212.309.6150
F +1.212.309.6001

Akshay N. Belani focuses his practice on the application of derivatives in trading, structured products, and capital markets. Akshay represents hedge funds, banks, institutional investors, broker-dealers and other financial institutions in all aspects of their futures, derivatives and commodities trading. He has experience in futures, derivatives and commodities laws, and regulations affecting both buy- and sell-side market participants and is a frequent speaker and writer on topics related to the new global derivatives market structure (with an emphasis on Dodd-Frank).

Akshay has been actively involved in the development of standardized documentation in the OTC and cleared derivatives markets and regularly advises clients on issues related to Dodd-Frank derivatives reform.

Bio

Charles R. Bogle

charles.bogle@morganlewis.com

101 Park Avenue

New York, NY 10178

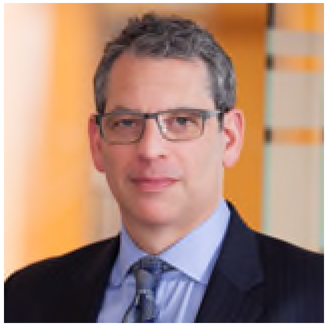
Phone: 212.309.6996

Fax: 212.309.6001

Charles (Chuck) Bogle is a tax partner with more than two decades of experience with the federal income tax aspects of all types of business transactions, including taxable and tax-free acquisitions and dispositions of equity and assets, "mezzanine" investments in subordinated debt and preferred stock, lending transactions, swaps and other derivative investments, asset securitizations, partnerships and joint ventures, and post-transaction tax planning, with a particular focus on the private equity, hedge fund, and investment management spaces.

Chuck has extensive involvement on both the "buy" and "sell" side of transactions, having represented: public and private acquirers, including merchant banks, investment funds and corporations with their investments and acquisitions; senior and mezzanine lenders, as well as borrowers, with credit transactions; and operating companies and their founders and principals with sales, IPOs and other transactions. Chuck also works across business sectors to help domestic and foreign clients comply with the provisions of the Foreign Account Tax Compliance Act (FATCA).

Bio



Daniel N. Budofsky

daniel.budofsky@morganlewis.com

101 Park Avenue

New York, NY 10178

Phone: +1.212.309.6160

Fax: +1.212.309.6001

Daniel N. Budofsky advises financial institutions, corporations, investment funds and asset managers on financial products in domestic and international transactions. He works on numerous derivatives and financing transactions, including fund derivatives, as well as a variety of complex structured products. Daniel's practice encompasses convertible, exchangeable and over-the-counter derivatives financing transactions. His clients include some of the largest financial institutions in the world as well as major endowments and "Fortune 50" companies.

Daniel acted as counsel to the Asset Management Group of the Securities Industry and Financial Markets Association (SIFMA) in connection with derivatives reform. He also represented the International Swaps and Derivatives Association (ISDA) in connection with the drafting of the 2006 Fund Derivatives Definitions and the 2011 Equity Derivatives Definitions projects.

Bio

Thomas V. D'Ambrosio

tdambrosio@morganlewis.com

101 Park Avenue

New York, NY 10178

Phone: 212.309.6964

Fax: 212.309.6001

Thomas V. D'Ambrosio concentrates his practice on structured and complex derivative transactions, including related insolvency and regulatory issues. Thomas helps clients structure, negotiate, and analyze the risk inherent in a wide range of derivative products, including equity, debt, credit, commodity, interest rate, currency, and exotic derivatives. His clients range from Fortune 500 corporations, private companies, investment managers and hedge funds, to financial institutions, pension funds, and high net-worth individuals.

Thomas is particularly active in advising enterprises that employ derivatives to hedge risks, monetize assets, and finance the acquisition of assets on favorable terms—with and without the benefits of leverage—including financing issuer equity and debt repurchase programs. He actively represents clients on Dodd Frank derivative reform.

Bio

Jedd H. Wider

jwider@morganlewis.com

101 Park Avenue

New York, NY 10178

Phone: +1.212.309.6605

Fax: +1.212.309.6001

Jedd H. Wider is Co-Head of Morgan Lewis' global Hedge Fund Practice. Jedd focuses on global private investment funds and managed accounts, particularly global hedge, private equity, secondary, and venture capital funds, and represents leading financial institutions, fund managers, and institutional investors in their roles as fund sponsors, placement agents, and investment entities. He assists clients through all stages of product development and capital raising as well as customized arrangements, seed and lead investor arrangements, and joint ventures. He also specializes in all aspects of secondary transactions, and complex financial structurings.

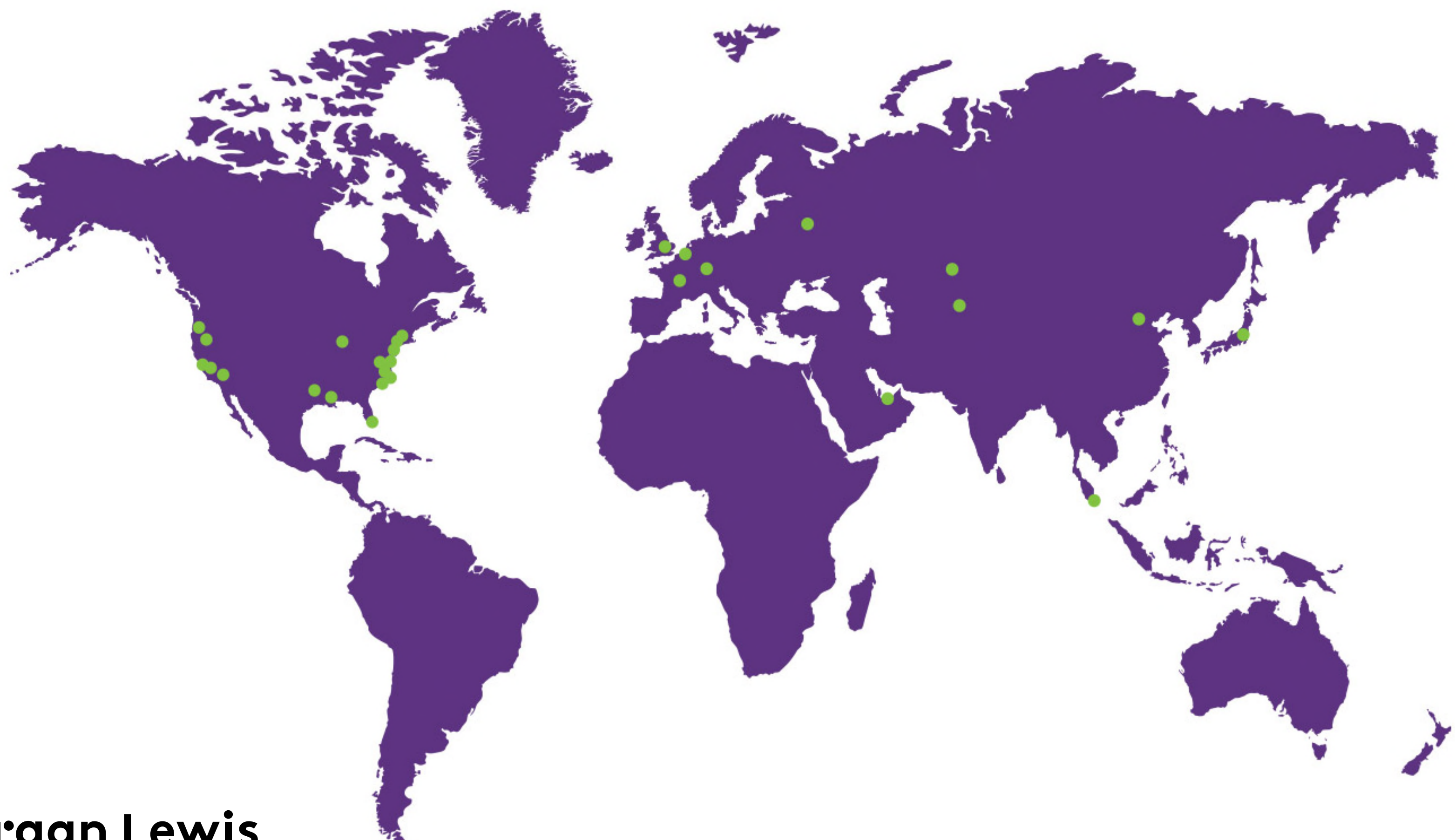
Jedd lectures and serves as a panelist on private investment fund topics for trade programs and organizations around the world. He has delivered speeches and presentations to numerous private fund conferences such as the Hedge Fund Institutional Forum, Dow Jones Private Equity Analyst Limited Partners Summit, Endowments & Foundations Roundtable, Association of Life Insurance Counsel, National Association of Public Pension Fund Attorneys (NAPPA), West Legalworks, InfoVest21 Hedge Fund Conference, and the Annual Euromoney Summit of European Hedge Funds in London.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Almaty
Astana
Beijing
Boston
Brussels
Chicago
Dallas
Dubai
Frankfurt
Hartford
Houston
London
Los Angeles
Miami
Moscow
New York
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Santa Monica
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



Morgan Lewis

THANK YOU