KAYE SCHOLER LLP

INVESTMENT FUNDS NEWSLETTER

Regulation of OTC Derivatives — Proposed Reforms in the U.S.

Madeleine M.L. Tan
Partner
Corporate & Finance
New York

The U.S. Congress is actively pursuing legislation relating to the regulation of the over-the-counter ("OTC") derivatives industry in the United States. While current provisions are vigorously debated, whatever regulations that are likely to be signed into law are sure to have a significant impact on the securitization market.

U.S. House of Representatives

On December 11, 2009, the U.S. House of Representatives (the "House") passed the *Wall Street Reform and Consumer Protection Act of 2009,* H.R. 4173 (by a vote of 223-202). Title III of H.R. 4173 contains the *Derivatives Transparency and Accountability Act of 2009* (the "House Bill"). The House Bill is substantially based on the Over-the-Counter Derivatives Markets Act of 2009, introduced by the Treasury Department in August 2009 (the "Treasury Bill") to regulate the OTC derivatives industry, and incorporates various provisions from bills approved and passed by the House Agriculture Committee and the House Financial Services Committee in October 2009. The House Bill also contains several important provisions that were debated heavily on the floor of the House, some of which (discussed below) reflect modifications to the original draft of the House Bill that are important to the securitization industry. The House Bill aims to comprehensively regulate the OTC derivatives industry and places shared regulatory jurisdiction on the Commodities Futures Trading Commission ("CFTC") and the Securities Exchange Commission ("SEC"). Principal features of the House Bill are discussed further below.

U.S. Senate

Several legislative proposals that affect OTC derivatives have been introduced in the Senate; including more recently, the *Restoring American Financial Stability Act of 2010*, (the "Senate Financial Reform Bill") proposed by Senator Dodd, on March 15, 2010. Included in the Senate Financial Reform Bill is a chapter relating to the regulation of OTC derivatives. However, the provisions in this chapter are substantially similar to the those introduced by Senator Dodd in November 2009. Although Democratic Senator Jack Reed and Republican Senator Judd Gregg were charged with rewriting this chapter, it was announced on March 19, 2010, that they failed to reach agreement. The Senate Financial Reform Bill (including the provisions regulating derivatives) was approved by the Senate Banking Committee on March 23, 2010, and will now be debated on the floor of the Senate. The table summarizes legislation introduced as of March 30, 2010.

Date	Sponsor(s)	Proposed Bill/Summary
January 15, 2009	Senator Tom Harkin (D-IA) (then-Chairman of the Senate Committee on Agriculture Nutrition and Forestry)	*Derivatives Trading Integrity Act of 2009*, S. 272 — amends the Commodity Exchange Act and requires that most OTC derivatives transactions be traded on exchanges regulated by the CFTC.

IN THIS ISSUE

Date	Sponsor(s)	Proposed Bill/Summary
April 2, 2009	Senator Ben Nelson (D-NE)	*SMART Energy Act of 2009*, S. 807 — places regulation of energy and emissions commodities under the jurisdiction of the CFTC.
May 4, 2009	Senators Carl Levin (D-MI) and Susan Collins (R-ME)	*Authorizing the Regulation of Swaps Act of 2009*, S. 961 — authorizes the CFTC and SEC to regulate swaps and oversee enforcement of rules and regulations. Encourages clearing and exchange-trading of swaps.
September 22, 2009	Senator Jack Reed (D-RI)	*Comprehensive Derivatives Regulation Act*, S. 1691 — requires standardized derivatives transactions to be cleared, but not necessarily traded, on regulated exchanges. All OTC transactions must be reported to trade repositories. The CFTC and the SEC would not have shared regulatory jurisdiction.
November 10, 2009	Senator Chris Dodd (D-CT) (Senate Banking Committee Chairman)	*Restoring American Financial Stability Act of 2009*, introduced as a discussion draft. This is a comprehensive bill proposing reform of the financial industry as a whole. Provisions on the regulation of derivatives are largely based on the Treasury Bill and bills passed by the House Committee on Agriculture and House Financial Services Committee in October 2009, aspects of which were incorporated into the House Bill.
March 15, 2010	Senator Chris Dodd (D-CT) (Senate Banking Committee Chairman)	*Restoring American Financial Stability Act of 2010.* This is a comprehensive bill proposing reform to the financial industry as a whole. Provisions on the regulation of derivatives are substantially similar to those contained in the bill introduced by Senator Dodd in November 2009.

Principal Features of the House Bill

In general, the House Bill requires that swap participants register as "swap dealers" or "major swap participants," and mandates that swaps entered into by such parties be cleared through a regulated clearinghouse and traded through a regulated exchange. The CFTC and SEC are given joint regulatory jurisdiction, with the SEC given jurisdiction over swaps that are based on securities, and swaps dealers and major swap participants that deal with such swaps. The CFTC will have jurisdiction over all other swaps. In this article, swaps and securities-based swaps are collectively referred to as "Swaps." The following is a summary of the principal features of the House Bill.

Who are Swap Dealers and Major Swap Participants?

- The House Bill defines a "swap dealer" as "any person who (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly engages in the purchase of swaps and their resale to customers in the ordinary course of a business; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps." A person may also be a "swap dealer" for a specific "type" or "class or category" of Swap but not for others.

- "Major swap participants" are, essentially, end-users of Swaps. The House Bill defines a "major swap participant" as a non-swap dealer who "maintains a *substan-*

tial net position in outstanding swaps, excluding positions held primarily for hedging, reducing or otherwise mitigating its commercial risk, or whose outstanding swaps create substantial net counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. (Emphasis added)." It is unclear what "*substantial net position*" means, and it remains open for the CFTC/SEC to define such term, but in doing so, the CFTC/SEC must determine a threshold that is prudent for the "effective monitoring, management and oversight" of entities that are systemically significant to the U.S. financial markets. The CFTC/SEC is also required to take into account such entity's relative position in uncleared and cleared swaps in making such determination.

- The exclusion contained the definition "major swap participant" exempts end-users of Swaps who enter into such Swaps to hedge commercial risks from the clearing requirement. This is an important exemption that was adopted in an amendment to the original text of the House Bill offered during the floor debate. The result for the securitization industry is that a standalone issuer in securitization transactions would not be required to register as a major swap participant and would not be required to comply with margin requirements that would otherwise be imposed on such persons (see "Prudential Regulation" below.) It is uncertain whether entities that have large swap books (*e.g.*, hedge funds) and who are not using Swaps to hedge commercial risks would be subject to the House Bill.

Registration of Swap Dealers and Major Swap Participants

Swap dealers and major swap participants are required to register with the CFTC/SEC and must comply with record-keeping and reporting requirements, as well as business conduct requirements (*e.g.*, verifying that their counterparties are "eligible contract participants"[1] and making certain enhanced risk disclosures to counterparties that are not swap dealers or major swap participants). Any Swap with a person who is not an "eligible contract participant" must be traded on an exchange.

> *The House Bill aims to comprehensively regulate the OTC derivatives industry and places shared regulatory jurisdiction on the Commodities Futures Trading Commission ("CFTC") and the Securities Exchange Commission ("SEC").*

Prudential Regulation

Swap dealers and major swap participants will be subject to capital and initial and variation margin requirements set jointly by the CFTC/SEC and the prudential regulators of the respective dealers and participants (*e.g.*, the Federal Reserve, OCC or FDIC, as appropriate)[2] with the aim to ensure the "safety and soundness of the swap dealer or major swap participant." It is expected that the capital requirements for Swaps that are not cleared through a clearinghouse (see below for further details) would be at least as high as the capital requirements for cleared Swaps, if not higher, to reflect the risks associated with the OTC nature of the Swap.

Segregation of Collateral

Swap dealers and major swap participants are required, if requested by their counterparties, to segregate the initial margin posted on Swaps that are not cleared with an independent third-party custodian. No segregation of collateral is required for cleared swaps, although the clearinghouses may continue its current practice of segregating collateral. An amendment proposed to the House Bill during debate on the floor requires that the independent third-party custodian not be substantially owned or controlled by the swap dealer, major swap participant or their respective counterparties.

Position Limits

The CFTC is required to set position limits[3] for all physically delivered commodity Swaps. The SEC will have authority to set position limits on listed securities underly-

[1] The House Bill amends the current definition of "eligible contract participant" as set forth in the Commodities Exchange Act, increasing the threshold for governmental entities owning and investing on a discretionary basis from \$25 million to \$50 million, and changing the individual threshold from at least \$10 million of total assets to at least \$10 million of invested assets on a discretionary basis.

[2] The prudential regulators are as follows: (i) OCC-prudential regulator for national banks and federally chartered branch or agency of a foreign bank, (ii) FDIC-prudential regulator for state-chartered banks that are not members of the Federal Reserve, and (iii) CFIC/SEC-prudential regulators of non-bank swap dealers and major swap participants.

[3] These position limits establish the aggregate number or amount of positions in contracts based on the same underlying commodity that may be held by any person on any designated contract markets, contacts traded on foreign boards of trade and contracts that are important for price discovery.

In general, the House Bill requires that swap participants register as "swap dealers" or "major swap participants," and mandates that swaps entered into by such parties be cleared through a regulated clearinghouse and traded through a regulated exchange.

ing securities-based Swaps, but is not required to do so. The position limits are designed to limit excessive speculation, ensure sufficient liquidity in the market and prevent market manipulation.

Clearinghouse and Exchange Trading

Clearinghouse

- All Swaps that a clearinghouse will accept for clearance and that are required by the CFTC and/or the SEC to be cleared, must be cleared through a clearinghouse.

- If a Swap cannot be cleared through a clearinghouse or if a clearinghouse will not accept it for clearance, the transaction must be reported to a "swap repository" or, if one does not exist or will not accept the Swap for reporting purposes, the CFTC/SEC. A swap repository is an entity that collects and maintains data on the terms of the Swap transactions and reports certain required information to the CFTC/SEC. The CFTC/SEC may also require that aggregate data regarding the Swaps be made publicly available.

- Commodity-based swaps that are physically settled, and foreign exchange forwards and swaps (unless the CFTC determines that such Swaps should be subject to the legislation) are exempted from the clearing requirement but must be reported to a swap repository or, failing that, the CFTC/SEC.

Trading on Exchanges

- All cleared Swaps must be traded on an exchange or traded on a swap execution facility. The House Bill defines a "swap execution facility" as "a person or entity that facilitates the execution or trading of security based swaps between two persons through any means of interstate commerce, but which is not a national securities exchange, including any electronic trade execution or voice brokerage facility." This definition is very broad and could potentially include any swap dealer or market maker. However, an important amendment offered by Rep. Stephen Lynch (D-MA) imposes limitation on the ownership of clearinghouses, exchanges that execute OTC products and swap execution facilities by restricting the beneficial ownership of such entities by swap dealers, major swap participants and certain related parties to 20%.

- A swap execution facility must register with the CFTC and comply with record-keeping and reporting rules imposed by the CFTC. In addition, conflict of interest rules must be complied with

Extraterritoriality

The House Bill does not apply to activities outside the U.S. unless such activities have a "direct and significant connection with activities in or effect on United States commerce; or contravene such rules or regulations" prescribed by the CFTC/SEC to prevent evasion of the new regulations.

Madeleine M.L. Tan
mtan@kayescholer.com

Willys H. Schneider

Partner

Tax

New York

IRS Focuses Attention on Total Return Swaps

In a recent pronouncement, the Internal Revenue Service (the "IRS") indicated that it is taking a hard look at certain "total return swaps" ("TRSs") involving non-U.S. counterparties. Specifically, in December 2009, the IRS issued an "industry director directive" ("IDD") intended to guide field auditors in identifying situations involving TRS transactions that may have been executed in order to avoid U.S. withholding tax on U.S. source dividends paid to nonresident alien individuals, foreign partnerships and foreign corporations (each referred to in the IDD as a "Foreign Person"). As such, the IDD is of critical significance to off-shore hedge funds, non-U.S. pension funds and other non-U.S. investors engaging in TRSs that reference U.S. securities.

If a TRS is respected for tax purposes as a notional principal contract ("NPC"), payments made thereunder to Foreign Persons are generally not subject to U.S. withholding tax. The intent of the IDD is to provide guidance in determining when a transaction that is in form a TRS should be respected as an NPC and when, by contrast, the Foreign Person should be treated as having retained tax ownership of securities referenced under the TRS. In the latter case, the Foreign Person may be subject to U.S. withholding tax (and the counterparty on the TRS may become a withholding agent).

Interestingly, the IDD is limited to situations where the counterparty is a "U.S. Financial Institution," including as such a U.S. branch of a non-U.S. bank. Presumably, this reflects a recognition by the IRS as to the practical limits of its ability to enforce withholding tax obligations. The IDD mandates particular scrutiny where the Foreign Person owned U.S. equity securities prior to entering into a TRS referencing such securities and where non-public U.S. equity securities are involved.

In December 2009, the IRS issued an "industry director directive" ("IDD") intended to guide field auditors in identifying situations involving TRS transactions that may have been executed in order to avoid U.S. withholding tax on U.S. source dividends paid to a "Foreign Person."

Targeted TRS Scenarios — Public U.S. Equity Securities

The IDD describes four factual situations pegged as representative examples of common TRS transactions. The first three involve situations in which the Foreign Person owns an equity security issued by a publicly-traded U.S. corporation that pays regular and/or extraordinary dividends with respect to its stock, and thereafter sells it to a U.S. Financial Institution acting as a broker/dealer. The Foreign Person then enters into a TRS with the U.S. Financial Institution (or, in one of the scenarios, a foreign affiliate thereof, which, in turn, enters into a mirror swap with the U.S. Financial Institution to eliminate or substantially reduce its risk with respect to its position under the TRS). The sale and entering into of the TRS is referred to as a "cross-in."

The TRS references the U.S. equity securities sold (the "U.S. referenced securities") and the notional amount of the TRS equals the fair market value of such securities. Under the TRS, the Foreign Person is required to make payments to the swap counterparty based on an interest component (such as a Libor-based payment) and any depreciation with respect to the notional investment in the U.S. referenced securities. The swap counterparty is required to make payments to the Foreign Person in an amount equal to any appreciation with respect to the notional investment in the U.S. referenced securities and any dividends paid with respect thereto.

The Foreign Person holds its position in the swap while dividends are paid. Following this, the Foreign Person terminates the swap, and at the same time repurchases the U.S. referenced securities from the U.S. Financial Institution (or its foreign affiliate), or, in one of the situations, from an unaffiliated third party. This termination and repurchase is referred to as a "cross-out." The IDD posits that the fair market value of the U.S. referenced securities on the cross-in, and the repurchase price on the cross-out, are likely to be determined so as to insure that the Foreign Person has no pricing risk, but retains overall ownership risk.

In examining these types of transactions, IRS agents are directed to identify situations where the Foreign Person maintained control over the U.S. referenced securities so as to create an agency relationship between the Foreign Person and the U.S. Financial Institution (or affiliate); the Foreign Person has maintained elements of beneficial ownership of the U.S. reference securities, resembling a sale and repurchase agreement or other similar arrangement; or where the transaction may be treated in substance as a securities lending transaction, loan or other similar arrangement. Where the cross-out involves reacquisition from a third party unaffiliated with the U.S. Financial Institution, the direction is to develop facts showing an arrangement involving the Foreign Person and either the U.S. financial institutions, the third party or both, with respect to the repurchase (for example, if either party to the swap engages an interdealer broker to act as an intermediary to facilitate the cross-out where pricing risk on the cross trades is eliminated for both parties). Where the TRS is entered into with an affiliate of the U.S. Financial Institution, both the TRS between the Foreign Person and the affiliate, and the TRS between the affiliate and the U.S. Financial Institution, will be examined.

In the fourth (so-called "fully synthetic") situation, it is assumed that the Foreign Person never owned the referenced U.S. equity securities. The U.S. Financial Institution hedges its position under the swap. In such cases, the field is instructed not to pursue any recharacterization of the transaction unless facts indicate that the Foreign Person exercised control with respect to the U.S. Financial Institution's hedge and, therefore, may have obtained beneficial ownership of the U.S. referenced securities as a result of entering into the TRS. For example, if a Foreign Person holds a TRS position that is so large or so illiquid that a U.S. Financial Institution acting as the swap counterparty must acquire the underlying security itself to hedge its position, the Foreign Person may be considered the beneficial owner of the U.S. referenced securities.

TRSs Involving Private U.S. Securities

The IDD also instructs agents to examine **any** transaction where a Foreign Person has entered into a TRS that references an equity security of a privately-held U.S. corporation, including, but not limited to, where the structure resembles any of those described above (*i.e.,* presumably including if the Foreign Person did not previously own the U.S. referenced securities). The stated rationale here is that a Foreign Person likely maintains control with respect to such private securities such that the Foreign Person may be considered the beneficial owner thereof.

Other TRSs

Finally, agents are instructed to examine any transaction where the Foreign Person entered into a TRS using an automated trading program offered by the U.S. Financial Institution that would allow the Foreign Person simultaneously and automatically to trigger the U.S. Financial Institution's execution, acquisition, and disposition of the TRS and the U.S. referenced securities, thus allowing the Foreign Person effectively to control acquisition and disposition of the securities, with the U.S. Financial Institution assuming no pricing risk. Again, the rationale is that this would be a situation in which the Foreign Person may be considered the beneficial owner of the U.S. referenced securities for U.S. income tax purposes.

* * *

Non-U.S. investors engaging in TRSs referencing U.S. equity securities should review the terms thereof with an eye to determining if they may be subject to IRS challenge in accordance with the IDD guidelines described. They should also take note of the possibility that TRS transactions similar to those described in the IDD, but involving non-U.S. financial institution counterparties, may be vulnerable to IRS challenge in that the tax considerations thereof are virtually identical to those described herein.

Willys H. Schneider
wschneider@kayescholer.com

U.K. Court of Appeal Confirms Toughened HM Revenue and Customs Approach to U.K. Tax Residence Challenges

Daniel Lewin

Partner
Tax

London

The decisions of the U.K. Court of Appeal are the latest in a number of high-profile wins for HMRC in residency challenges of taxpayers who claimed to have relinquished U.K. tax residence.

In a judgment with potentially material implications for individuals considering spending only part of their time working in the U.K., in *R on the application of Davies and another v. Commissioners for HMRC* and *R on the application of Gaines-Cooper v. Commissioners for HMRC* (the appeals were heard jointly), the U.K. Court of Appeal dismissed the taxpayers' claims that HM Revenue and Customs ("HMRC") had failed to comply with its existing practice in determining U.K. residency. The decisions of the U.K. Court of Appeal are the latest in a number of high-profile wins for HMRC in residency challenges of taxpayers who claimed to have relinquished U.K. tax residence.

In *Davies*, the taxpayers had homes in the U.K. and Belgium, whereas in *Gaines-Cooper*, the taxpayer argued that he had moved his residence to Seychelles. A key aspect of the appeals was the allegation that HMRC had failed to comply with its then-current HMRC publication IR20, which, among other, set out the no more than "90 days in the U.K." test on which the taxpayers had sought to rely in refuting their U.K. tax residence claims.

The Court, in dismissing the taxpayers' arguments, held that, in the circumstances, HMRC had correctly applied IR20 in refusing the taxpayers to rely on a mere 90-day count in relinquishing U.K.-tax residence, and that HMRC were permitted to increase, without warning, the intensity of inquiry or scrutiny of claims to be non-U.K.-resident.

Specifically, for U.K.-resident taxpayers seeking to leave the U.K. and become non-resident, it was either necessary to demonstrate that they had left the U.K. to work full-time abroad and had done so for the whole tax year in question (*i.e.*, the foreign contract of employment covered each day of the relevant tax year), or alternatively, the taxpayer had to show a distinct break from existing social, work and family ties in the U.K.

While not entirely surprising, the judgments, therefore, confirmed that mere reliance on the 90-day count for the maximum number of days spent in the U.K. was not sufficient to establish non-residence in circumstances where the taxpayer had previously been U.K. resident and was moving abroad for reasons other than taking up full-time employment. Rather, the U.K. taxpayer had to show that he had severed his ties with the U.K. to the extent that his previous social and family ties in the U.K. are no longer retained.

The decision will therefore be of importance to U.K. managers in the alternative investment funds industry who wish to mitigate their U.K. income tax liabilities by moving residence to another

The decision will therefore be of importance to U.K. managers in the alternative investment funds industry who wish to mitigate their U.K. income tax liabilities by moving residence to another jurisdiction and/or spending a limited amount of time in the U.K.

jurisdiction and/or spending a limited amount of time in the U.K. The Court also rejected the taxpayers' claims (supported by considerable evidence from leading tax practitioners) that HMRC changed its application of IR20, holding that HMRC was entitled to move from an attitude of arguably passive tolerance to more active investigation.

The 90-day test remains relevant in ensuring that individuals who are non-U.K.-resident do not acquire U.K. tax residency (one of the implications of the judgment is the fact that it is comparatively easier to avoid becoming U.K.-resident, than to lose U.K. residence once acquired).

While not of help to the taxpayers in the present appeals, some comfort can be derived from the Court's decision that taxpayers are entitled to rely on HMRC's Statements of Practice as binding on HMRC (technically, these do not have the force of "law") — *e.g.*, U.K.-based hedge fund managers commonly need to rely on the Statement of Practice 1/01 for the safe harbors of the Investment Manager Exemption.

Daniel Lewin
dlewin@kayescholer.com

FSA Announces New Rules for Funds of Alternative Investment Funds

Simon Firth

Partner
Corporate & Finance

London

Owen D. Watkins

Consultant
Corporate & Finance

London

The FSA has indicated that once a sufficient number of FAIFs have been established, it will conduct a post-implementation review into the working of the rules, to see whether the FSA's desired policy outcomes are being achieved.

On February 26, 2010, the FSA published Policy Statement ("PS") 10/3, "Funds of Alternative Investment Funds (FAIFs)". This much-delayed paper responds to a consultation that took place in February 2008 on certain aspects of FAIFs; indeed, the original consultation on introducing FAIFs dates back to March 2007. The FSA gave no reason for the delay, but since the success of the FAIFs regime will depend on appropriate taxation regulations, one might guess that at least some of the delay (outside the global credit crisis) was taken up in developing such regulations with HM Treasury and HM Revenue and Customs. As noted below, new taxation regulations came into force at the same time as the new FAIFs regime, on March 6, 2010.

FAIFs are a type of non-UCITS scheme that may be marketed to retail investors (such schemes are known in the FSA rules as "NURS"). Although, like other NURS, FAIFs are subject to various investment restrictions (such as a restriction on the type of investments that can be made and on their over-the-counter ("OTC") derivative exposure), they will operate under a more relaxed regime. In particular, FAIFs will be able to invest up to 100% of the scheme property in collective investment schemes that satisfy specified requirements, and to invest in a single master scheme.

PS 10/3 sets out the FSA's responses to five questions raised in the February 2008 consultation:

1. **Repayment standards.** The original FSA proposal to use existing repayment standards (including payment for a redeemed unit within four business days following redemption) has been significantly amended, in response to comments that such a proposal would have made the operation of FAIFs unworkable. Fund managers now have up to 185 days to pay redemptions from the receipt and acceptance of an instruction to redeem. Details of the redemption procedure must be disclosed in the FAIF documentation so that the investor fully understands the arrangements. This is particularly important given that FAIFs can be marketed to retail investors.

2. **Master/feeder structures.** Unsurprisingly, the proposal allowing master/feeder structures received widespread support. However, the FSA has concluded that where a master/feeder structure is used to achieve the FAIF's objectives, the master fund, being a substitute for the feeder fund, must abide by the rules of the feeder scheme; if this were not done, the master scheme could be used to circumvent the restrictions on the feeder scheme. The feeder fund's manager is therefore responsible for ensuring that the

Under new tax regulations that came into effect at the same time as FSA's FAIFs rules, FAIFs with investments in non-reporting offshore funds (such FAIFs are termed "Funds Investing in Non-Reporting Funds" or "FINROFs" for the purposes of the tax regulations) are subject to special treatment.

master fund abides by the rules in FSA's Collective Investment Schemes sourcebook ("COLL"), and will be potentially liable for any failure.

3. **Strengthened due diligence approach.** The majority of respondents agreed with the FSA's proposals in this area (which have been supported by events since the original consultation, notably the Madoff frauds). The FSA has decided to go further than originally proposed and to strengthen requirements in relation to custody and valuation. Consequently, a FAIF manager is required to carry out initial and ongoing due diligence both to determine that the property of the underlying scheme is held by an independent third party, and to ensure that the calculation of an underlying firm's NAV and the maintenance of its accounting records are segregated from the scheme's investment management function.

4. **Genuine diversity of ownership ("GDO")**. FSA had originally proposed that COLL should contain provisions requiring any FAIF to have GDO built into its trust deed/instrument of incorporation and repeated in its prospectus. However, under new tax regulations that came into effect at the same time as FSA's FAIFs rules, FAIFs with investments in non-reporting offshore funds (such FAIFs are termed "Funds Investing in Non-Reporting Funds" or "FINROFs" for the purposes of the tax regulations) are subject to special treatment. Where such investments exceed 20% of the FINROF's gross asset value, or alternatively where the FINROF makes an election, the FINROF will not be subject to tax on gains realised from investments in such non-reporting offshore funds, as long as certain conditions are satisfied. Instead, the investors in the FINROF will be taxed on income in relation to any gains made on disposal of their respective interests in the FINROF.

   Given that the GDO condition has been designed for funds that want to offer capital treatment to investors for trading transactions, and that investors in FAIFs that qualify as FINROFs will be taxed to income on their entire gain (including investments that would otherwise have resulted in capital treatment), the FSA has concluded that GDO requirements in COLL are no longer necessary.

5. **Cost-benefit analysis.** FSA received no comments on the cost-benefit analysis on which it consulted. The FSA points out that the feedback it has received suggests that the costs of developing the systems capable of handling dealing and repayment frequencies of up to 185 days are in the region of £500,000, though the exact amount will vary from firm to firm. These and other additional costs may, as the FSA concedes, deter some firms from entering the FAIF market, although it might be possible for some of the costs to be passed on to the FAIFs themselves, rather than being borne by the firms.

As noted above, as FAIFs are a type of NURS, they will be subject to certain spread restrictions set out in COLL 5.7.5R. The FSA has rejected the argument put forward (in particular by hedge fund managers) that an increase in leverage limits from 10% of NAV would be necessary to manage fund liquidity. Nor has it accepted that the rules should be changed to widen the scope of investment in commodities (the current rules allow investment in only one commodity, gold; up to 10% of the fund), though its comments suggest that it recognises that this is illogical.

FSA received no comments on the cost-benefit analysis on which it consulted. The FSA points out that the feedback it has received suggests that the costs of developing the systems capable of handling dealing and repayment frequencies of up to 185 days are in the region of £500,000, though the exact amount will vary from firm to firm.

The FSA also notes that the proposed Alternative Investment Fund Managers Directive ("AIFMD"), the text of which is currently being negotiated, may have an impact on the FAIFs regime. This is because the scope of the AIFMD may, once the text is finally agreed upon, cover NURS currently operated by individual Member States, and thus restrict the scope of those Member States to make their own rules (as well as requiring them to amend their existing rules). However, given that there is considerable uncertainty as to what the final text of the AIFMD might be, the FSA has decided to bring the FAIF rules in at this point in time, rather than wait for that uncertainty to be resolved. As European finance ministers have subsequently postponed a decision on the AIFMD to an unspecified date, this looks to be a good call by the FSA.

The FSA has indicated that once a sufficient number of FAIFs have been established, it will conduct a post-implementation review into the working of the rules, to see whether the FSA's desired policy outcomes are being achieved.

It will be interesting to see the extent to which U.K. investment managers take up the new opportunities presented by FAIFs. They already have available a regulated U.K. onshore product that can be marketed to investors in the form of a qualified investor scheme ("QIS"). QISs have wider investment powers than other authorized investment funds, and are subject to lighter regulation. However, as the name suggests, QISs can be marketed only to "qualified investors" — typically corporations or sophisticated high net-worth individuals — and they have not proved popular, in large part because of the unfavorable tax treatment for investors (QISs not being tax transparent). In contrast, the fact that FAIFs can be marketed to retail investors, plus the favorable tax treatment described above, suggests that FAIFs are likely to be far more successful than QISs, and of genuine interest to a wide range of investors.

Simon Firth
sfirth@kayescholer.com

Owen D. Watkins
owatkins@kayescholer.com

U.K. Supreme Court Landmark Ruling on Valuation of Shares in Private Equity Portfolio Companies

The judgment in *Grays Timber Products Ltd v HMRC (Scotland) [2010] UKSC 4* provides a novel approach on how "market value" should be interpreted in the context of personal rights relating to shares. The result will affect the structuring of share incentives in private companies, including private equity companies.

On February 3, 2010, the Supreme Court published its judgment in Grays Timber Products Limited. Under the terms of a subscription and shareholders' agreement entered into by the managing director at the time he acquired his shares, the director was entitled to a 25% share of the consideration on a sale of the company, even though he only held around 6% of the shares. The Supreme Court confirmed the decision of the Court of Session that the consideration that the director received in excess of his *pro rata* share holding was paid to him in recognition of his services and therefore taxable as income from employment (with PAYE and NIC obligation on the company).

The case was the first occasion on which the U.K. courts have ruled on the highly complex "employment-related securities" legislation within Part 7 of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA"). Under Chapter 3D of Part 7 ITEPA where employment-related securities are disposed of for more than market value, the disposal proceeds in excess of market value are taxable as employment income.

In deciding whether Chapter 3D applied, the court had to determine what the "market value" of the director's shares was, and specifically, how the special compensation rights were to be analysed. Broadly, tax legislation defines market value as the price that a hypothetical purchaser might reasonably pay for an asset in a sale on the open market.

The following two key issues arose:

- Firstly, should the shares be valued on the basis simply of their rights set out in the articles (which did not make reference to additional consideration), or should the right to additional consideration in the subscription and shareholders' agreement be taken into account?

- Secondly, even if the rights in the subscription and shareholders' agreement were treated as if set out in the articles, should they nevertheless be disregarded in the valuation as exclusively personal to the director in question and worthless to a purchaser?

The Supreme Court upheld the decision of the lower courts that the rights were personal to the director and therefore to be disregarded: the subscription and shareholders' agreement explicitly stated that the entitlement to additional consideration was in recognition of the personal services of the managing director.

On the facts, the decision was therefore the correct result, but the significance of the judgment lies in the court's analysis as to which factors are to be taken into account in determining market value (and, therefore, the proportion of the consideration that attracts the more favorable capital treatment).

Crucially, the court held that the rights were personal, did not transmit to the purchaser and were not therefore rights to be taken into account in ascertaining the market value of the shares, commenting that this would be the result whether or not the rights were attached to the shares.

It was commonly thought that, so long as rights were contained in the articles, they would be taken into account in determining market value of the shares as "intrinsic" to the shares. The judgment casts some doubt that this is always the case.

Chicago Office +1.312.583.2300	**Frankfurt Office** +49.69.25494.0	**London Office** +44.20.7105.0500
Los Angeles Office +1.310.788.1000	**Menlo Park Office** +1.650.319.4500	**New York Office** +1.212.836.8000
Shanghai Office +86.21.2208.3600	**Washington, DC Office** +1.202.682.3500	**West Palm Beach Office** +1.561.802.3230