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THE NEW DEAL: HEDGE FUND MANAGEMENT FEES ARE SUBJECT TO SOCIAL SECURITY TAXES

MARK LEEDS

THIS ARTICLE DISCUSSES IRS CHIEF COUNSEL ADVICE 201436049, WHICH ADDRESSES THE STRUCTURE OF HOLDING HEDGE FUND MANAGEMENT FEE INTEREST IN THE FUND, AND THE ASSERTION MADE BY THE IRS. IT ALSO EXAMINES AN ALTERNATE STRUCTURE THAT WOULD HAVE LESSENED THE LIKELIHOOD OF THIS ASSERTION.

It's probably fair to speculate that there were significant numbers of tax aficionados (including the author of this article) among the audience for Ken Burns' recent public television extravaganza on the Roosevelt dynasty. Unfortunately for this segment of the audience, the intersection of tax and FDR was not highlighted, with the passage of the Social Security Act receiving only scant mention. Social security taxes have risen dramatically since the enactment of the law. As a result, these taxes have a more prominent role in tax planning than Mr. Burns gave them in his not-so-mini-series. A recent Internal Revenue Service ("IRS") audit ruling highlights planning traps that can dramatically affect when Social Security taxes can be imposed.

On September 5, 2014, the IRS released Chief Counsel Advice 201436049. This CCA addresses an all-too-common structure employed by hedge fund managers to hold the management fee interest in the fund. The structure employed by the funds in CCA 201436049 resulted in the IRS arguing that the full management fee should be subject to Social Security taxes. An alternate structure would have lessened the likelihood of this assertion. This article describes the facts presented by the CCA and the assertion made by the IRS. It also examines an alternate structure and how the use of the alternate structure could mitigate the possible imposition of self-employment tax imposed by Section 1402(a) of the Internal Revenue Code of 1986, as amended (the "Code") and the Medicare Tax imposed on net investment income ("NII") by Code § 1411.

BACKGROUND

The facts described in CCA 201436049 should sound familiar to any tax person who has spent time structuring hedge funds. At the bottom of the structure was a limited partnership (the "Master Fund").[1] Third party investors purchased limited partnership interests in the Master Fund.

The Master Fund had two general partners: (1) Management Company, and (2) Profits GP.[2] The Management Company was organized as a limited liability company (an "LLC") taxable as a partnership. The Management Company had the "full authority and responsibility to manage and control the affairs and business" of Master

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Fund. This included all investment activities, such as the purchasing, managing, restructuring, and selling of the Master Fund's investment assets. Employees and members of the Management Company conducted these operations. The Master Fund paid a management fee to the Management Company in exchange for these services. The management fee constituted all of the Management Company's gross receipts in the years under IRS audit.

CCA 201436049 recites that all of the members (partners) in the Management Company were individuals. Certain members paid significant sums for their Management Company equity units. Although redacted, it appears that each of such members spent more than 500 hours per year on the business of the Management Company which, as stated above, was conducting investment activities for the Master Fund. The Management Company paid wages to its members[3] and employees, but the facts of the CCA show that the payment of wages did not zero out the income of the Management Company. Accordingly, the Management Company had residual income that it allocated to its members. This income was allocated *pro rata* by the number of Management Company equity units held by each of its members.

The Management Company did not withhold Social Security taxes on the distributive share of the Management Company net income that was allocated to its members. This failure by the Management Company to withhold Social Security taxes was the subject of CCA 201436049. The IRS asserted that the Management Company should have withheld these taxes.

CODE § 1402 AND NET EARNINGS FROM SELF-EMPLOYMENT

Under current law, Federal Insurance Contribution Act ("FICA") taxes are imposed on wages, i.e., income from employment paid by an employer. Under a complementary regime, Self-Employment Contributions Act ("SECA") taxes are imposed on earnings from self-employment. For individuals who receive compensation for services from entities taxable as partnerships in which they hold partnership interests, SECA taxes apply. The IRS has ruled FICA does not apply to a partner's partnership income because a partner cannot be an employee of a partnership of which he is a partner.[4]

SECA has three components:

1. The OASDI tax, imposed at a 12.4% tax on net earnings from self-employment ("NESE") up to $117,000 for 2014 (the "OASDI cap"). The OASDI cap is indexed annually for inflation.
2. The Hospital Insurance ("HI") tax. The HI tax is imposed at a 2.9% rate on NESE. There is no cap on the HI tax and it applies to every dollar of NESE.
3. The HI High Earner Surtax. The HI High Earner Surtax is a .9% tax that applies to NESE in excess of $200,000 ($250,000 for married individuals filing a joint return).
4. Code § 1401(a), (b)(1). NESE is defined in Code § 1402(a) and can include an individual's distributive

share of income from any trade or business carried on by a partnership in which he is a partner.

Net Earnings From Self-Employment and LLCs and LLPs

Code § 1402(a)(13) excludes "the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in Section 707(c) … for services actually rendered to or on behalf of the partnership, to the extent that those payments are established to be in the nature of remuneration for those services" from the definition of NESE. Congress added Code § 1402(a)(13) in 1977 in order to prevent individuals from grossing-up their NESE by their distributive share of partnership income from partnerships when the allocation of partnership income was not compensation for the performance of services.[5] Thus, Code § 1402(a)(13) carves out a limited partner's distributive share of partnership income from the definition of NESE. The enactment of Code § 1402(a)(13) preceded the rapid growth in popularity of LLCs and other limited liability pass-through entities.[6] As noted in the CCA, the scope of activities of the typical limited partner back then was significantly limited compared to the modern limited partner of a LLC. Under the Revised Uniform Limited Partnership Act of 1976, if a "limited partner" took part in the control of the partnership's business, such person would lose limited liability protection.

Proposed Regulations. Over time, however, as national incomes approached and then exceeded the Social Security cap described above, the focus of the government changed. The IRS, instead of seeking to prevent individuals from including partnership income in their Social Security tax base, wrote rules that curtailed the ability of limited partners to exclude partnership income from NESE. Specifically, in January 1997, the IRS proposed regulations (the "1997 Proposed Regulations") that generally would have prevented partners (including LLC members) who, among other things, provided more than 500 hours of service to the partnership from being treated as "limited partners" for Code § 1402(a)(13) purposes.[7] However, in August 1997, Congress imposed a one-year moratorium preventing the Treasury from adopting regulations dealing with the employment tax treatment of limited partners (the "1997 Moratorium").[8] The moratorium expired on July 1, 1998. The 1997 Proposed Regulations were never adopted, even after the 1997 Moratorium expired. CCA 201436049 briefly discusses the 1997 Proposed Regulations in passing, but focuses its analysis on legislative history and case law.

Legislative History. The legislative history of Code § 1402(a)(13) demonstrates a shift from subjecting all of partner's distributive share to self-employment tax, regardless of such partner's role and responsibilities in his capacity as a partner, to a recognition that "certain earnings which are basically of an investment nature" should be exempt.[9] However, Congress drew a line: "The exclusion from [Social Security] coverage would not extend to guaranteed payments (as described in 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership."[10] In CCA 201436049, the IRS concluded that the intent of the statute was to exempt individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations.

Judicial Authorities. The IRS in CCA 201436049 grounded its assertion that income allocated by the Management Company to its member should be subject to NESE on the decision in *Renkemeyer*, *Campbell & Weaver*, LLP.[11] The taxpayers at issue in that case were attorney-members of a Kansas LLP engaged in the practice of law. Each LLP member was provided with the same liability protection as a limited partner. The LLP reported business revenues from its law practice on IRS Forms 1065 for the relevant tax years, but no portion of those revenues was included on the law firm's tax returns as NESE. The IRS asserted that the attorney-partners' distributive shares of the law firm's business income for the relevant tax years was subject to self-employment tax. As in the CCA, the *Renkemeyer* court's decision turned on whether the attorney-partners were "limited partners" under Code § 1402(a)(13).

1 The CCA involved several hedge funds, all utilizing the same structure. For ease of presentation, however, we'll only refer to a single fund.

2 Profits GP, which had a substantial interest in the master Fund's gains and losses but generally did not take part in the conduct or control of the activities of the Master Funds. The activities of Profits GP were not addressed in the CCA and will not be addressed in this article.

3 It is likely that the amounts paid to members should not have constituted wages reported on an IRS Form W-2. In Rev. Rul. 69-184, the IRS held that the partners described were not employees of their partnership for employment tax purposes. Although no rationale was given in the ruling, the underlying GCM 34001 (Dec. 23, 1968) suggests that there was a concern that, for reasons of administrative convenience to the IRS, individuals should not be permitted to hold a dual capacity as employed and self-employed for employment tax purposes with respect to the same entity. A recent district court decision cited the 1969 ruling for the proposition that "'a partner who participates in the partnership business is 'a self-employed individual [and not an employee]. "' *Riether v. United States*, 919 F. Supp. 2d 1140 (D. NM. 2012), 112 AFTR 2d 2013-6074).

4 Rev. Rul. 69-184, 1969-1 C.B. 256.

5 *See* H.R. Rep. No. 95-702(I), pp. 40-41 (1977).

6 The first LLC Act was adopted in Wyoming in 1976, but LLCs did not become truly widespread for over another decade.

7 Additionally, an individual could not claim to be a limited partner if he or she has personal liability for the debts or claims against the partnership by reason of being a partner or has authority to contract on behalf of the partnership. The 1997 Proposed Regulations also provided that service providers in service partnerships (*e.g.*, law firms, accounting firms, and medical practices) may not be limited partners.

8 H.R. 2014 Sec. 734 (1997) on Sec. 935 "Moratorium on certain Regulations," Taxpayer Relief Act of 1997, P.L.105-34.

9 H.R. 95-702 (Part 1), at 11 (1977).

10 *Id.*

11 136 TC 137 (2011).

The taxpayers in *Renkemeyer* claimed their respective interests in the law firm shared the characteristics of limited partnership interests because (i) their interests were designated as limited partnership interests in the law firm's organizational documents and (ii) the partners enjoyed limited liability pursuant to Kansas law. Hence, they argued, their distributive shares of the law firm's business income qualified for the Code § 1402(a)(13) exception. The Tax Court distinguished general partners from limited partners by explaining that "[g]eneral partners typically have management power and unlimited personal liability[, whereas] limited partners lack management powers but enjoy immunity from liability for debts of the partnership."[12] The court held the attorneys were not limited partners.

THE IRS IN CCA 201436049 GROUNDED ITS ASSERTION THAT INCOME ALLOCATED BY THE MANAGEMENT COMPANY TO ITS MEMBER SHOULD BE SUBJECT TO NESE ON THE DECISION IN *RENKEMEYER, CAMPBELL & WEAVER*, LLP.

The *Howell* [13] case, which was not discussed in the CCA, also sheds light on when an individual should be treated as a limited partner for purposes of Code § 1402(a)(13). This case involved the contention by a member of Intelemed, LLC, a limited liability company taxable as a partnership, that she was a "limited partner" whose share of earnings was not subject to self-employment tax pursuant to Code § 1402(a)(13). Intelemed was a medical technology company that provided software and hardware to hospitals. Although the taxpayer had no background in engineering or computer technology (unlike her husband, who was an employee of Intelemed), the IRS claimed there was evidence that, among other things, she signed contracts on behalf of Intelemed, made significant purchases for Intelemed, executed tax returns on behalf of Intelemed, and received a stream of payments consistent with compensation treatment. Finally, the IRS contended that the taxpayer's capital contributions to the LLC (all non-cash) "are not the type of contributions typically made by a passive investor." The taxpayer's capital contributions, as described in the LLC's operating agreement, were intellectual property, a business plan, and organizational design plans.

Intelemed deducted its payments to the taxpayer as guaranteed payments under Code § 707(c) on its Form 1065 tax returns for 2000 and 2001, and reported the payments as guaranteed payments on her Schedules K-1 for such years. The taxpayer did not report the payments as subject to self-employment tax on her Form 1040 tax returns for those years, but rather as partnership distributions.

The IRS set forth numerous arguments against the taxpayer, including that she "was an active participant in Intelemed and consequently she may not exclude the payments from her net earnings from self-employment under section 1402(a)(13)." The IRS's brief discusses *Renkemeyer* and quotes the legislative history of Code § 1402(a)(13), discussed above, regarding the kind of partner Congress had in mind for the self-employment tax exemption. Concomitantly, the court held that the legislative history "does not support the holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners" from self-employment taxes:

> In *Renkemeyer*,... we applied accepted principles of statutory construction to decide whether the taxpayers' partnership interests in a law firm should be considered limited partner interests for purposes of section 1402(a)(13), stating as follows:
>
> `The insight provided reveals that the intent of section 1402(a)(13) was to insure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations ... would not receive credits toward Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.'
>
> `This Court held that the taxpayers were not limited partners for purposes of section 1402(a)(13) because the distributive shares received 'arose from legal services ... [the taxpayers] performed on behalf of the law firm' and 'did not arise as a return on the partners' investment.'

The Tax Court held that the taxpayer was subject to self-employment tax, but did not strictly follow *Renkemeyer*. Although the opinion in *Howell* quotes essentially the same portion of *Renkemeyer* as appears in the government's brief, the *Howell* opinion, in its analysis of the arguments, does not apply or even cite *Renkemeyer*.

CCA 201436049 does, however, discuss the decision in *Riether v. U.S.*[14] The *Riether*s were husband and wife and together they owned an LLC engaged in diag-

[12] Although the opinion does not state that the IRS concluded the partners were "general partners" for purposes of Code § 1402(a)(13), the IRS's brief (not cited or discussed in the opinion) makes it clear that the IRS would apply the state law characterization approach to subject all of the LLP's members to self-employment tax. Under this approach, the state law characterization of each member of the unincorporated limited liability entity as a general or limited partner would control for federal tax purposes. The IRS observed that (i) the partnership itself was organized and operated as an LLP, (ii) an LLP was a general partnership (not a limited partnership) under Kansas partnership law, and (iii) under that law, there were no limited partners in an LLP. Each attorney received his share of ordinary income from the law partnership as a general partner. Therefore, in the view of the IRS, the attorneys were not "limited partners" eligible for the Code § 1402(a)(13) exclusion from self-employment tax.

[13] TC Memo 2012-303.

[14] 919 F. Supp. 2d 1140 (D. NM. 2012, 112 AFTR 2d 2013-6074).

nostic imaging. The LLC paid the couple wages[15] and treated the excess of the income of the LLC over the amount paid as wages as their distributive share of partnership income. The *Riether*s did not pay NESE on their distributive share of LLC. The court characterized this reporting as trying "to treat themselves as employees for *some* of the LLC's earnings, by issuing themselves . . . wages while simultaneously treating themselves as partners for *the rest* of the LLC's earnings."[16] The court then focused on whether the limited partner exception of Code § 1402(a)(13) applied. The IRS asserted that NESE taxes applied to this income. The court held that the *Riether*s acted as general partners of the LLC and, accordingly, the limited partner exception did not apply.

Application to the LLC in CCA 201436049

The IRS, relying on *Renkemeyer* and *Riether*, *supra*, ruled that the members of the Management Company could not rely on the limited partner exception of Code § 1402(a)(13) to avoid the imposition of NESE taxes on their distributive share of Management Company income. Dismissing the fact that certain of the members had paid substantial sums for their Management Company units, the IRS held that the Management Company earnings "are not in the nature of a return on capital investment . . . [but] are a direct result of the services rendered on behalf of the Management Company by its Partners." Accordingly, the IRS refused to allow the members of the Management Company escape the imposition of the NESE tax by reason of the application of the limited partner exception.

CODE § 1411 AND THE MEDICARE TAX

For tax years beginning on or after January 1, 2013, Code § 1411 generally imposes a 3.8% Medicare tax (the "Medicare Tax") on net investment income ("NII") of U.S. individuals, trusts, and estates.[17] The term "NII" is defined for this purpose to mean any income falling into one of the following three categories (net of allocable expenses):[18]

1. Income from interest, dividends, annuities, royalties, and rents, except when those items are derived in the ordinary course of a trade or business not described in category 2.[19]
2. Other gross income derived in a trade or business involving trading in financial instruments or commodities or from an active trade or business in which the taxpayer is passive (for example, income from the taxpayer's investment in a business activity in which he does not materially participate).[20]
3. Net gain from the disposition of property, except when that property is held in a trade or business not described in category 2.[21]

THE IRS, RELYING ON *RENKEMEYER* AND *RIETHER, SUPRA*, RULED THAT THE MEMBERS OF THE MANAGEMENT COMPANY COULD NOT RELY ON THE LIMITED PARTNER EXCEPTION OF CODE § 1402(A)(13) TO AVOID THE IMPOSITION OF NESE TAXES ON THEIR DISTRIBUTIVE SHARE OF MANAGEMENT COMPANY INCOME.

The Medicare Tax applies to a trade or business if it is (i) a passive activity with respect to the taxpayer within the meaning of Code § 469 (the passive activity loss or PAL rules) or (ii) a trade or business of trading in financial instruments or commodities, as defined in Code § 475(e)(2).[22] If a taxpayer is active in a trade or business, he still will have NII from non-business income from interest, dividends, annuities, royalties, rents, and capital gains, minus allocable deductions. Code § 1411 does not define the term "trade or business." The proposed regulations under Code § 1411 specify that an activity is passive with respect to a taxpayer if it is (i) a trade or business within the meaning of Code § 162 and (ii) that trade or business is a passive activity within the meaning of Code § 469 as to the taxpayer.[23]

The determination of whether an item of gross income allocated to a taxpayer from a pass-through entity, such as a partnership or an S corporation, is derived from a trade or business in which the taxpayer materially participates is made at the taxpayer level(individual, estate, or trust) in accordance with the general principles of Code § 469.[24] The proposed regulations provide the following example that demonstrates the result in tiered pass-through entities:

15 The opinion in *Riether* notes that this reporting is inconsistent with the rule in Revenue Ruling 69-184 and that the IRS did not object to this reporting.
16 Emphasis in original.
17 For individuals, the tax applies only if the individual's modified adjusted gross income for the tax year exceeds a threshold amount equal to $200,000 (for single taxpayers) or $250,000 (for married taxpayers filing joint returns). See Section 1411(b).
18 Code § 1411(c).
19 Prop. Treas. Reg. § 1.1411-4(a)(1)(i).
20 Prop. Treas. Reg. § 1.1411-4(a)(1)(ii), 5(a)(2).
21 Prop. Treas. Reg. § 1.1411-5(a)(iii).
22 Code § 1411(c)(2).
23 Prop. Treas. Reg. § 1.1411-5(a).
24 Preamble to REG-130507-11.

A, an individual, owns an interest in UTP, a partnership, which is engaged in a trade or business. UTP owns an interest in LTP, also a partnership, which is not engaged in a trade or business. LTP receives $10,000 in dividends, $5,000 of which is allocated to A through UTP. The $5,000 of dividends is not derived in a trade or business because LTP is not engaged in a trade or business. This is true even though UTP is engaged in a trade or business. Accordingly, the ordinary course of a trade or business exception described in paragraph (b) of this section does not apply, and A's $5,000 of dividends is net investment income under paragraph (a)(1)(i) of this section.[25]

The PAL Material Participation Rules

As noted above in the discussion of the Medicare Tax, a trade or business is not considered to be passive with respect to a taxpayer if the taxpayer "materially participates" in the conduct of such trade or business.[26] Code § 469(h)(1) provides that a taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial.[27] Treasury Regulation § 1.469-5T provides additional guidance for individuals on the meaning of "material participation."

THE GENERAL "MATERIAL PARTICIPATION" TEST OF CODE § 469(H)(1) HAS BEEN REFINED BY THE MORE DETAILED REGULATORY TESTS CONTAINED IN TEMPORARY TREASURY REGULATION § 1.469-5T(A)(1)-(7).

With respect to the term "participation," regulations provide that generally "any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated for purposes of this section as participation of the individual in the activity."[28] Treasury Regulation § 1.469-5T(f)(2)(ii)(A) provides, however, that work done by an individual in such individual's capacity as an investor in an activity shall not be treated as participation by the individual in the activity unless the individual is involved in the day-to-day management or operations of the activity. Work done by an individual in the individual's capacity as an investor in the activity includes studying and reviewing financial statements or reports on operations of the activity, preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use, and monitoring the finances or operations of the activity in a non-managerial capacity.[29]

The general "material participation" test of Code § 469(h)(1) has been refined by the more detailed regulatory tests contained in Temporary Treasury Regulation § 1.469-5T(a)(1)-(7). The Temporary Regulations provide seven alternatives for determining whether an individual should be treated as "materially participating" in an activity during a year:

1. The individual participates in the activity for more than 500 hours during such year.
2. The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year.
3. The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year.
4. The activity is a "significant participation activity" (within the meaning of Temp. Treas. Reg. § 1.469-5T(c)) for the taxable year,[30] and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours.
5. The individual materially participated in the activity (determined without regard to Treas. Reg. § 1.469-5T(a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year.
6. The activity is a "personal service activity" (within the meaning of Treas. Reg. § 1.469-5T(d)), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.
7. Based on all of the facts and circumstances (taking into account the rules in Treas. Reg. § 1.469-5T(b)), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Code § 469(h)(2) treats losses from certain limited partnership interests as *per se* passive. Specifically, Code § 469(h)(2) provides "no interest in a limited partnership as a limited partner shall be treated as an interest with

25 Prop. Treas. Reg. § 1.1411-4(b)(3) Ex. 1.
26 Code § 469(c)(1)(B).
27 Code § 469(h)(1); Treas. Reg. § 1.469-5T(a)(7).
28 Treas. Reg. § 1.469-5(f)(1).
29 *See* Treas. Reg. § 1.469-5(f)(2)(ii)(B).
30 An activity is a "significant participation activity" pursuant to Treas. Reg. § 1.469-5T(c) only if (1) the activity is a trade or business, (2) the individual participates in the activity for more than 100 hours during the year, and (3) the individual cannot establish material participation under any of the other material participation tests in the regulations.

respect to which a taxpayer materially participates."[31] For this purpose, Temporary Treasury Regulation § 1.469-5T(e)(3)(i) provides that a partnership interest is treated as a "limited partnership interest" under one of the following circumstances:

(A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or (B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership).

IN DIRECT CONTRAST TO THE POSITION OF THE IRS IN *RENKEMEYER, HOWELL* AND *RIETHER, SUPRA*, THE IRS HAS ARGUED THAT LLC MEMBERS (AND, IN ONE CASE, LLP MEMBERS) ARE "LIMITED PARTNERS" FOR PURPOSES OF CODE § 469 BECAUSE OF THEIR LIMITED LIABILITY UNDER THE RELEVANT STATE LAW STATUTES.

The Temporary Regulations, however, provide an exception to the general presumption of non-material participation for limited partners. Specifically, Temporary Treasury Regulation § 1.469-5T(e)(2) provides that if the taxpayer is a limited partner of a limited partnership, but meets test (1), (5) or (6) of the seven material participation tests set forth in Temporary Treasury Regulation § 1.469-5T(a)(1)-(7) (see above), the taxpayer will be considered to materially participate in the activity of the partnership. Stated differently, a limited partner in a partnership can satisfy one of three tests ((1), (5) or (6)) to establish that he or she materially participates in the partnership's activity.

Another important exception (the so-called "general partner exception") is for a limited partner holding a general partner interest. Specifically, an individual holding a partnership interest will not be treated as a limited partner for the purpose of these rules if such individual is also a general partner in the partnership.[32] The general partner exception has been recently discussed by the courts in several cases involving taxpayers holding interests in limited liability companies (LLCs) and limited liability partnerships (LLPs).

In direct contrast to the position of the IRS in *Renkemeyer, Howell* and *Riether, supra*, the IRS has argued that LLC members (and, in one case, LLP members) are "limited partners" for purposes of Code § 469 because of their limited liability under the relevant state law statutes. The courts disagreed with the IRS in all four cases.[33] In *Garnett v. Commissioner*, a case dealing with both LLPs and LLCs, Paul and Alicia Garnett owned interests in several limited liability companies and partnerships and tenancies-in-common that engaged in agricultural business operations. The Garnetts had direct interests in one LLP and one LLC and indirect interests in several other LLPs and LLCs. They were listed as limited partners in the LLP ventures and as limited liability company members in the LLCs. The IRS disallowed certain losses the Garnetts claimed related to their interests in the LLPs and LLCs, saying they failed to meet the participation requirements of Code § 469. The Garnetts argued that Code § 469(h)(2) did not apply to their situation because none of the entities were a limited partnership and because the Garnetts were general, rather than limited, partners. The IRS argued that the Garnetts' interests qualified as limited partnership interests and did not qualify as general partner interests for purposes of Code § 469.

The Tax Court first considered whether Code § 469(h)(2) is applicable to LLCs and LLPs, which were either new or nonexistent business entities when Code § 469 was enacted in 1986. The Tax Court began its analysis stating that Temporary Treasury Regulation § 1.469-5T(e)(3)(i) (see above) would appear to treat such LLC and LLP interests as a "limited partnership interests." Nevertheless, the Tax Court emphasized that if the general partner exception applies then the ownership interest "shall not be treated as a limited partnership interest." Stated differently, even if the taxpayers

[31] *See also* Temp. Treas. Reg. § 1.469-5T(e)(1) ("an individual shall not be treated as materially participating in any activity of a limited partnership for purposes of applying section 469… and the regulations thereunder to — (i) The individual's share of any income, gain, loss, deduction, or credit from such activity that is attributable to a limited partnership interest in the partnership").

[32] *See* Temp. Treas. Reg. § 1.469-5T(e)(3)(ii).

[33] *See Garnett v. Commissioner*, 132 T.C. No. 19 (2009) (Tax Court held that a couple's interests in several LLPs and LLCs) do not qualify as limited partnership interests, and are not subject to the rule in Code § 469); *Hegarty v. Commissioner*, T.C. Summ. Op. 2009-153 (Oct. 6, 2009) (Tax Court held that a couple materially participated in the charter fishing business they operated through an LLC and their deductions for losses from that business were not subject to Code § 469); *Thompson v. United States*, 87 Fed. Cl. 728 (2009) (Court of Federal Claims held that Temp Treas. Reg. § 1.469-5T(e)(3) "… is simply inapplicable to a membership interest in an LLC," and even if it would apply to the taxpayer, the taxpayer's interest in the LLC "would best be categorized as a general partner's interest…", citing *Garnett v. Commissioner* with approval); *Newell v. Commissioner*, T.C. Memo 2010-23 (Tax Court has held that a couple properly deducted losses from an LLC in which the husband held a managing member interest, finding that he materially participated in the company and was not a limited partner for purposes of applying the passive activity loss rules of Code § 469). The IRS made the same argument in an older case, *Gregg v. United States,* 87 AFTR2d ¶ 2001-311 (U.S. District Court held that the limited partnership test in Code § 469 is obsolete when applied to LLCs and their members). It is worth noting that this litigating position is directly contrary to the position taken by the IRS in *Renkemeyer* and *Howell*, *supra*.

were to be treated as limited partners in the LLPs and LLCs, if they were to be treated also as general partners in these entities, then they would not be treated as limited partners for purposes of Code § 469. Thus, the issue addressed by the Tax Court was whether the general partner exception applied.

The Tax Court emphasized that Congress enacted Code § 469(h)(2) to address the statutory constraints on a limited partner's ability to participate in the partnership's business and that a member of an LLC or partners in an LLP are not similarly constrained. Because a member of an LLC or a partner in an LLP, unlike a limited partner in a limited partnership, is not prohibited by state law from participating in the partnership's business, he or she more closely resembles a general partner. As a result, the Tax Court concluded that a member of an LLC and a partner in an LLP should be treated as a general partner for purposes of Code § 469 and, as such, should be treated as a general partner for purposes of Temporary Treasury Regulation § 1.469-5T(e)(3)(ii).

The Tax Court further provided that the general partner exception is not expressly confined to the situation where a limited partner also holds a general partnership interest in a partnership. The exception provides that an individual who is a general partner is not restricted from claiming that he materially participated in the partnership. After examining the legislative history of Code § 469 and taking into account the lack of any prohibition regarding participation in management under state law, the Tax Court concluded that the general partner exception was broad enough to cover the activity of a taxpayer who holds an interest in an LLP or LLC and is authorized by state law to participate in managing the entity.

As the courts explained in these cases, in both LLCs and LLPs, the members/partners can maintain limited liability status while actively participating in the activity of the entity, as opposed to a limited partnership, where state laws generally prohibit the partners from actively participating in the business if they desire to maintain limited liability status.[34] The IRS argued in all cases that the important factor that should render a member in an LLC and partner in an LLP a limited partner (and not general partner) for purposes of Code § 469(h)(2) is the limited liability awarded to both members in an LLC and partners in an LLP.[35] The courts, however, chose to focus on the right to participate in the business (which the courts consider as critical under Code § 469) rather than the limited liability.

The Treatment of Gain From the Disposition of Interests in Pass-Through Entities Under the Medicare Tax

In general, gain from the disposition of an interest in a pass-through entity is not subject to the Medicare Tax on NII to the extent that the gain is attributable to assets held in the conduct of an active trade or business (other than the trading of stock, securities and commodities) in which the taxpayer materially participates. The statute, Code § 1411, does not directly address the taxation of gain from the disposition of interests in pass-through entities under the Medicare tax. The approach taken by the proposed Medicare regulations to reach this conclusion is circuitous.

THE TAX COURT EMPHASIZED THAT CONGRESS ENACTED CODE § 469(H)(2) TO ADDRESS THE STATUTORY CONSTRAINTS ON A LIMITED PARTNER'S ABILITY TO PARTICIPATE IN THE PARTNERSHIP'S BUSINESS AND THAT A MEMBER OF AN LLC OR PARTNERS IN AN LLP ARE NOT SIMILARLY CONSTRAINED.

Proposed Treasury Regulation § 1.1411-4(d)(3)(ii)(B)(1) provides that an interest in a pass-through entity, such as a partnership or an S corporation, is not considered to be property held in a trade or business. This rule, taken on a stand-alone basis, would imply that gain from the disposition of an interest in a pass-through entity would be subject to the Medicare Tax imposed on NII. Proposed Treasury Regulation § 1.1411-4(d)(3)(iii), however, provides that the gain that is potentially subject to the Medicare Tax is adjusted as provided in Proposed Treasury Regulation § 1.1411-7. Two requirements must be met in order for the modification rules in Proposed Treasury Regulation § 1.1411-7 to apply:

1. The pass-through entity must be engaged in at least one trade or business other than the trading of stocks, securities or commodities; and
2. The transferor of the interest in the pass-through entity must satisfy the material participation test with

[34] *See e.g.*, *Gregg v. United States*, 186 F. Supp 2d at 1128.

[35] *See* e.g., *Thompson v. United States*, 87 Fed. Cl. 728 (2009), where the IRS argued that among the states allowing a limited partnership interest at the time section 469 was adopted, the key feature was limited liability. But the court refused to accept that view, holding that "limited liability is not the sine qua non of a limited partnership interest." Based on a review of the various limited partnership acts, the court said that the real determinative factor in creating a limited partnership interest was the level of participation in business control. "The tax code and the applicable regulations literally cannot be read to transfigure plaintiff's member interest in his LLC into one of a limited partnership," the court said.

respect to the trade or business conducted by the pass-through entity.

Prop. Treas. Reg. § 1.1411-7(a)(2).

If the two conditions precedent necessary for the modification rule apply, the gain potentially subject to the Medicare Tax on NII is reduced as follows:

1. The pass-through entity is deemed to have disposed of all of its properties in a taxable transaction for the fair market value of the properties.
2. The pass-through entity computes the gain or loss that would be recognized in the deemed dispositions.
3. The pass-through entity then allocates to the transferor the gain or loss that would be allocated to the transferor under the pass-through entity agreement as modified by applicable tax rules.
4. To the extent that there is a net gain attributable to assets used in a trade or business (other than trading stocks, securities or commodities) in which the taxpayer materially participates, such net gain is subtracted from the gain from the disposition of the interest in the pass-through entity that is potentially subject to the Medicare Tax on NII.[36]

STRUCTURING TO ALLEVIATE THE BURDENS OF THE NESE AND MEDICARE TAXES

If the Management Company in CCA 201436049 had been organized as a limited partnership instead of as an LLC, with the members holding limited partnership interests, the members would have been on a much stronger footing to avoid the application of the NESE tax. In addition, for 2013 and years after, provided that each limited partner dedicated more than 500 hours towards the business of the Management Company, each limited partner should be able to avoid the application of the Medicare Tax to his or her allocable share of Management Company income. Notwithstanding the IRS's dismissive attitude towards the fact that members of the Management Company paid substantial sums for his or her interest in the Management Company, this fact supports the conclusion that the limited partner exception should apply to amounts allocated to members through their limited partnership interests. Assuming each limited partner paid cash for his or her limited partnership interest, *Howell* supports the conclusion that such a contribution would be of a type made by a passive investor. (Recall that the taxpayer's contribution to Intelemed was all non-cash and deemed "not the type of contributions typically made by a passive investor.")

This conclusion is supported by the fact that the *Howell* decision did not strictly rest on the conclusion that the LLC interest held by the taxpayer should not be treated as a limited partnership interest for purposes of Code § 1402(b)(13). The decision rested on the fact that the taxpayer made non-cash contributions that were tangible results of services, provided services to the partnership and received no other form of compensation.

IF THE MANAGEMENT COMPANY IN CCA 201436049 HAD BEEN ORGANIZED AS A LIMITED PARTNERSHIP INSTEAD OF AS AN LLC, WITH THE MEMBERS HOLDING LIMITED PARTNERSHIP INTERESTS, THE MEMBERS WOULD HAVE BEEN ON A MUCH STRONGER FOOTING TO AVOID THE APPLICATION OF THE NESE TAX.

The decisions in the PAL cases discussed above, *Garnett, Hegarty, Thompson* and *Newell*, *supra*, should not be relevant to the determination of whether the limited partnership interests held by a partner who also renders services should be treated as a limited partnership interests for purposes of Code § 1402(a)(13). First, on a substantive level, the purposes of the two tests are distinct. The NESE rules are testing as to whether income allocated to an individual should be treated as compensation for services. The purpose of the PAL rules is to deny the use of losses from passive investments against income earned from activities in which the taxpayer is actively involved. When the taxpayer is actively involved, regardless of the type of interest held by the taxpayer, the rationale for limiting the use of passive losses is not met. This conclusion is borne out by the general partner exception discussed above. Second, none of the PAL cases were cited by the courts in *Renkemeyer* and *Howell*, *supra*. If the treatment of LLC interests for PAL purposes was relevant for purposes of the limited partner exception contained in Code § 1402(a)(13), it is reasonable to expect that the Tax Court would have cited its holdings in the NESE cases. The conclusion on this point is reinforced by the 1997 Moratorium. This is clear evidence of Congressional intent that the combination of an individual providing services to an LLC and who holds an LLC interest should not be treated *per se* as

[36] *Vice versa*, if there is a net loss from the disposition of assets used in a trade or business (other than trading stocks, securities or commodities) in which the taxpayer materially participates, the net loss is added to the overall gain recognized from the disposition of investment assets or assets used in a trade or business in which the taxpayer did not materially participate in.

a general partner with respect to the income earned through the limited partner interest for purposes of Code § 1402(a)(13).

CHANGE IN LAW RISK

There have been a number of federal income tax bar developments that have recommended changes to the rules discussed above. In January 2013, the New York State Bar Association (the "NYSBA") released a report entitled, "Comments on the Application of Employment Taxes to Partners and the Interaction of the Section 1401 Tax with the New Section 1411" (the "NYSBA Social Security Tax Report"). In the NYSBA Social Security Tax Report, the NYSBA urged the IRS to re-adopt the 1997 Proposed Regulations. The recommendation extended to subjecting all partnership income to SECA taxes if the partner (limited or not) performed material services for the partnership. On April 15, 2013, Victor Fleisher, a tax law professor, published an article in the *New York Times* titled, "The Top 10 Private Equity Loopholes." In the article, Professor Fleisher noted that "Through careful structuring, some fund managers take their income through a limited partnership in which they are technically 'limited partners' in the management company ... Allocations to limited partners, however, are neither subject to the Medicare Tax as self-employment income nor as investment income under section 1411." Professor Fleisher goes on to recommend that Congress or the IRS adopt the recommendations in the NYSBA Social Security Tax Report.

Given the recent commentary regarding the potential for persons treated as partners for federal income tax purposes to structure their ownership in businesses in which they perform services to generate income that is not subject to either SECA taxes or Medicare taxes, it is possible that the law could change in the future.

MARK LEEDS is a tax partner with the New York office of Mayer Brown and the editor-in-chief of *Derivatives: Financial Products Report.*

CFTC PROPOSED MARGIN REQUIREMENTS FOR UNCLEARED SWAPS UNDER DODD-FRANK

DAVID J. GILBERG, KENNETH M. RAISLER and MEGAN R. O'FLYNN

THIS ARTICLE EXAMINES THE COMMODITY FUTURES TRADING COMMISSION'S REPROPOSED RULES FOR MINIMUM MARGIN REQUIREMENTS FOR SWAP DEALERS AND MAJOR SWAP PARTICIPANTS WHICH ARE LARGELY ALIGNED WITH THE PRUDENTIAL REGULATORS' RECENT REPROPOSED RULES.

On September 23, 2014, the Commodity Futures Trading Commission ("CFTC") issued a proposed rule to establish minimum initial and variation margin collection requirements for uncleared swaps entered into by certain swap dealers and major swap participants. With some exceptions, as discussed below, the proposal is substantially similar to the proposal promulgated collectively by the Federal Reserve Board, the Office of the Comptroller of Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Authority on September 3, 2014 concerning swap margin and capital requirements. The CFTC's reproposed rule supersedes the agency's previous proposal originally issued in April 2011, is intended to take into account the comments received by the CFTC in response to the 2011 Proposal and follows the promulgation of the international framework for margin requirements of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps finalized in September 2013 by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions. If adopted, the proposed rule would require that swap dealers and major swap participants subject to the jurisdiction of the CFTC collect and post minimum initial and variation margin amounts from and to certain swap counterparties, depending on the type of counterparty, in connection with swap transactions. Comments are due to the CFTC by sixty (60) days after publication in the Federal Register.

BACKGROUND

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requires that, subject to certain exemptions, standardized swaps be cleared through a regulated clearing house that is registered under the Commodity Exchange Act ("CEA") as a Derivatives Clearing Organization ("DCO"). For uncleared swaps, i.e., those swaps not cleared through a DCO, Dodd-Frank creates a new Section 4s of the CEA that requires the adoption of rules establishing initial margin, variation margin and capital requirements for swap dealers, major swap participants, security-based swap dealers and major security-based swap participants, as those terms have been defined by the Securities and Exchange Commission (the "SEC") and the Commodity Futures

Trading Commission ("CFTC") (collectively, "Swap Entities").[1] Swap Entities subject to regulation by the Federal Reserve Board, the Office of the Comptroller of Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Authority (collectively, the "Prudential Regulators") must meet the margin and capital requirements determined by the applicable Prudential Regulator. Swap Entities for which there is no Prudential Regulator must meet the margin and capital requirements imposed by the CFTC or the SEC, as applicable.

The CFTC first issued its proposed rule regarding margin requirements for uncleared swaps applying to Swap Entities for which it is the regulator on April 14, 2011, and ultimately received 102 comments on the proposal from a variety of entities including financial services industry associations, agricultural industry associations, energy industry associations, insurance industry associations, banks, brokerage firms, investment managers, insurance companies, pension funds, commercial end users, law firms and public interest organizations.[2] The Prudential Regulators issued their initial proposed rule regarding margin and capital requirements related to swaps on April 12, 2011,[3] and the SEC issued its proposed rule for Swap Entities for which it is the regulator on October 18, 2012.[4] In July of 2012, the Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO") issued a proposed framework for margin requirements regarding certain swaps with the goal of creating an international standard for margin requirements for such swaps (the "International Framework"). Following public comment on the proposal, the International Framework was finalized by BCBS and IOSCO in September 2013.[5] The reproposed rule disseminated by the CFTC on September 23, 2014 (the "CFTC's Proposed Rule")[6] endeavors to address the comments received regarding the agency's prior proposal and to be consistent with the International Framework, and, subject to the exceptions described herein, is substantially similar to the Prudential Regulators' reproposed rule disseminated by the Prudential Regulators on September 3, 2014 (the "Prudential Regulators' Proposed Rule").[7]

THE CFTC'S PROPOSED RULE

The CFTC staff "worked closely with the staff of the Prudential Regulators," in addition to consulting with the SEC, in developing the CFTC's Proposed Rule, and, with some exceptions described below, the CFTC's Proposed Rule and the Prudential Regulators' Proposed Rule are substantially similar. For an in-depth discussion of the Prudential Regulators' Proposed Rule, covering aspects of proposal including the scope of counterparties covered, requirements surrounding initial margin and variation margin, eligible collateral and segregation requirements, see our memo to clients entitled "Proposed Margin Requirements for Uncleared Swaps Under Dodd-Frank," dated September 10, 2014.[8]

Documentation Requirements and Control Mechanisms

Under the Prudential Regulators' Proposed Rule, a Swap Entity subject to regulation by the Prudential Regulators is not required to collect initial margin with respect to uncleared swaps with a counterparty that is neither a financial end user with material swaps exposure nor another Swap Entity. A Prudential Regulator-regulated Swap Entity is also not required to collect variation margin with respect to uncleared swaps with a counterparty that is neither a financial end user nor another Swap Entity, but must collect such margin "at such times and in such forms and such amounts (if any), that the [Prudential Regulator-regulated Swap Entity] determines appropriately address the credit risk posed by the counterparty and the risks of such [uncleared] swaps." Swap documentation by a Prudential Regulator-regulated Swap Entity with regard

SWAP ENTITIES FOR WHICH THERE IS NO PRUDENTIAL REGULATOR MUST MEET THE MARGIN AND CAPITAL REQUIREMENTS IMPOSED BY THE CFTC OR THE SEC, AS APPLICABLE

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1 For a more in-depth discussion of the definitions of swap dealer, security-based swap dealer, major swap participants and major security-based swap participant, please see the our memo to clients entitled "Proposed Swap Definitions Under Title VII of the Dodd-Frank Act," dated December 14, 2010, available at http://www.sullcrom.com/Proposed-Swap-Definitions-Under-Title-VII-of-the-Dodd-Frank-Act.

2 See our memo to clients entitled "Proposed Margin Requirements for Uncleared Swaps Under Dodd-Frank," dated April 18, 2011, available at http://sullcrom.com/Proposed-Margin-Requirements-for-Uncleared-Swaps-under-Dodd-Frank.

3 *Id.*

4 See our memo to clients entitled "Security-Based Swaps: Capital, Margin and Segregation Requirements," dated November 19, 2012, available at http://www.sullcrom.com/Publication_Proposed_Rules_on_Capital_Requirements_Margin_for_Security_Based_SDs_and_MSPs.

5 BCBS and IOSCO, Margin Requirements for Non-Centrally Cleared Derivatives (Sept. 2013), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf.

6 See http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister092314a.pdf.

7 See http:'>//www.federalreserve.gov/newsevents/press/bcreg/20140903c.htm; Proposed Rules and comments, available at http://www.regulations.gov (Docket No. OCC-2011-0008).

8 Memo available at http://sullcrom.com/proposed-margin-requirements-for-uncleared-swaps-under-dodd-frank-09-10-2014.

to margin must include trading documentation with each counterparty that is another Swap Entity or a financial end user regarding credit support arrangements that (i) provides the Swap Entity and its counterparty with the contractual right to collect and post initial margin and variation margin in such amounts, in such form, and under such circumstances as are required by the margin rules; and (ii) specifies the methods, procedures, rules, and inputs for determining the value of each uncleared swap for purposes of calculating variation margin requirements, as well as the procedures by which any disputes concerning the valuation of uncleared swaps, or the valuation of assets collected or posted as initial margin or variation margin, may be resolved.

The CFTC's Proposed Rule, in contrast, requires that a Swap Entity subject to regulation by the CFTC enter into documentation with all counterparties, including nonfinancial entities, to provide clarity about the parties' respective rights and obligations. However, a CFTC-regulated Swap Entity would be free to set initial margin and variation margin requirements, if any, with nonfinancial entities in its discretion and any thresholds agreed upon by the parties would be permitted. Under the CFTC's Proposed Rule, margin documentation must specify (i) the methodology and data sources to be used both to value uncleared swaps and collateral and to calculate initial margin as well as to value position and to calculate variation margin for uncleared swaps entered into between the Swap Entity and its counterparty; (ii) the procedures by which any disputes concerning the valuation of uncleared swaps, or the valuation of assets posted as initial margin or paid as variation margin, may be resolved; (iii) any thresholds below which initial margin need not be posted by the Swap Entity and/or its counterparty; and (iv) any thresholds below which variation margin need not be paid by the Swap Entity and/or its counterparty.

Each CFTC-regulated Swap Entity must also create and maintain documentation setting forth the variation margin methodology with sufficient specificity to allow the counterparty, the CFTC, and any applicable Prudential Regulator to calculate a reasonable approximation of the margin requirement independently. The CFTC-regulated Swap Entity must evaluate the reliability of the data sources used for its methodology at least annually and make appropriate adjustments based on such evaluation, and the CFTC reserves its right to require a Swap Entity to provide further data or analysis related to its methodology.

Under the Prudential Regulators' Proposed Rule, a Swap Entity subject to regulation by the Prudential Regulators must conduct a review of its initial margin model at least annually in light of developments in financial markets and modeling technologies, and must make appropriate enhancements. In addition, a Prudential Regulator-regulated Swap Entity must comply with specific control, oversight and valuation mechanisms, including ongoing monitoring processes that are designed to verify internal processes and benchmarking by comparing such Swap Entity's initial margin model outputs (estimation of initial margin) with relevant alternative internal and external data sources to ensure that the initial margin required is not less than what a derivatives clearing organization or a clearing agency would require for similar cleared transactions.

UNDER THE PRUDENTIAL REGULATORS' PROPOSED RULE, A SWAP ENTITY SUBJECT TO REGULATION BY THE PRUDENTIAL REGULATORS IS NOT REQUIRED TO COLLECT INITIAL MARGIN WITH RESPECT TO UNCLEARED SWAPS WITH A COUNTERPARTY THAT IS NEITHER A FINANCIAL END USER WITH MATERIAL SWAPS EXPOSURE NOR ANOTHER SWAP ENTITY.

The CFTC's Proposed Rule includes requirements similar to those of the Prudential Regulators' Proposed Rule with regard to control mechanisms for initial margin and also sets forth more detailed requirements with regard to control mechanisms for variation margin. Under the CFTC's Proposed Rule, a CFTC-regulated Swap Entity must calculate variation margin on a daily basis for itself and for each counterparty that is a Swap Entity or a financial end user, using a methodology and inputs that to the maximum extent practicable rely on recently executed transactions, valuations provided by independent third parties, or other objective criteria. The CFTC-regulated Swap Entity must also have alternative methods for determining the value of an uncleared swap in the event of the unavailability or other failure of any input required to value a swap.

In addition, in contrast to the Prudential Regulators' Proposed Rule, under the CFTC's Proposed Rule, a CFTC-regulated Swap Entity must calculate hypothetical initial and variation margin amounts each day for positions held by nonfinancial entities that have material swaps exposure to the CFTC-regulated Swap Entity – that is, the hypothetical calculations must be performed for each counterparty that has more than $3 billion in gross notional of uncleared swaps (as calculated under the CFTC's Proposed Rule) with the CFTC-regulated Swap Entity. A CFTC-regulated Swap Entity must calculate what the margin amounts would be if this nonfinancial counterparty were instead another Swap Entity and compare these hypothetical amounts to any actual margin requirements for the positions. This requirement is cited by the CFTC as a risk management tool to assist the CFTC-regulated Swap Entities in measuring counterparty risk embedded in uncleared, un-margined trades and to assist the CFTC in conducting oversight of such entities.

Cross-Border Application of the Margin Rules

The CFTC's Proposed Rule states that, "given the risk-mitigation function of the margin rules for uncleared swaps" the CFTC "believes that the rules should apply on a cross-border basis in a manner that effectively addresses risks" to the registered Swap Entities. However, the CFTC also states that "[a]t the same time, it may be appropriate, consistent with principles of international comity and statutory objectives underlying the margin requirements, to allow [Swap Entities] to satisfy the margin requirements by complying with a comparable regime in the relevant foreign jurisdiction, or to not apply the margin requirements under certain circumstances." Although it is unclear how foreign branches of a U.S. bank that is a Swap Entity would be subject to CFTC's margin rules, rather than the Prudential Regulators' margin rules, the CFTC's Proposed Rule includes such entities in describing three (3) alternative approaches to the cross-border applicability of its margin rules, as described below.

Cross-Border Guidance Approach. Under the Cross-Border Guidance Approach, the CFTC would apply the margin requirements consistent with the CFTC's cross-border guidance (the "Cross-Border Guidance").[9] The margin requirements would apply to a U.S. CFTC-regulated Swap Entity (other than a foreign branch of a U.S. bank that is a CFTC-regulated Swap Entity) for all of its uncleared swaps (as applicable), irrespective of whether its counterparty is a U.S. person or not, without substituted compliance, but would only apply to a non-U.S. CFTC-regulated Swap Entity (whether or not it is a "guaranteed affiliate"[10] or an "affiliate conduit")[11] only with respect to its uncleared swaps with a U.S. person counterparty (including a foreign branch of a U.S. bank that is a CFTC-regulated Swap Entity) and a non-U.S. counterparty that is guaranteed by U.S. person or is an affiliate conduit. Substituted compliance would be permitted where the counterparty is a guaranteed affiliate or an affiliate conduit pursuant to approval by the CFTC. For uncleared swap transactions between a non-U.S. CFTC-regulated Swap Entity (whether or not it is a guaranteed affiliate or an affiliate conduit) and a non-U.S. counterparty that is not a guaranteed affiliate or affiliate conduit, the margin requirements would not apply. Finally, for uncleared swap transactions between a foreign branch of a U.S. bank that is a CFTC-regulated Swap Entity, the margin requirements would apply to all such transactions with all counterparties, except that substituted compliance would be permitted, pursuant to CFTC approval, where the counterparty to the transaction is another foreign branch of a U.S. bank that is a CFTC-regulated Swap Entity or a non-U.S. person (whether or not it is a guaranteed affiliate or an affiliate conduit). A summary of the application of the margin requirements under the Cross-Border Guidance Approach, as provided in the CFTC's Proposed Rule, is shown in Table 1.

THE CFTC'S PROPOSED RULE STATES THAT, "GIVEN THE RISK-MITIGATION FUNCTION OF THE MARGIN RULES FOR UNCLEARED SWAPS" THE CFTC "BELIEVES THAT THE RULES SHOULD APPLY ON A CROSS-BORDER BASIS IN A MANNER THAT EFFECTIVELY ADDRESSES RISKS" TO THE REGISTERED SWAP ENTITIES.

Entity-Level Approach. Under the Entity-Level Approach, the CFTC would treat the margin requirements as an entity-level requirement. Here, the CFTC would

[9] CFTC, Interpretative Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013). In this document, the CFTC addressed, among other things, how the swap provisions in Dodd-Frank (including the margin requirement for uncleared (. . . continued) swaps) would apply on a cross-border basis. In this regard, the CFTC stated that as a general policy matter it would apply the margin requirement as a transaction-level requirement.

[10] Under the Cross-Border Guidance, *id*. at 45318, the term "guaranteed affiliate" refers to a non-U.S. person that is an affiliate of a U.S. person and that is guaranteed by a U.S. person. The CFTC's Proposed Rules note that "the scope of the term 'guarantee' under the Cross-Border Guidance Approach and the Entity-Level Approach would be the same as under note 267 of the [Cross-Border] Guidance and accompanying text."

[11] Under the Cross-Border Guidance, id. at 45359, the factors that are relevant to the consideration of whether a person is an "affiliate conduit" include whether: (i) the non-U.S. person is majority-owned, directly or indirectly, by a U.S. person; (ii) the non-U.S. person controls, is controlled by, or is under common control with the U.S. person; (iii) the non-U.S. person, in the regular course of business, engages in swaps with non-U.S. third party(ies) for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its U.S. affiliate(s), and enters into offsetting swaps or other arrangements with such U.S. affiliate(s) in order to transfer the risks and benefits of such swaps with third-party(ies) to its U.S. affiliates; and (iv) the financial results of the non-U.S. person are included in the consolidated financial statements of the U.S. person. Other facts and circumstances also may be relevant.

TABLE 1:

	U.S. Person (other than Foreign Branch of U.S. Bank that is a CFTC-Regulated Swap Entity)	Foreign Branch of U.S. Bank that is a CFTC-Regulated Swap Entity	Non-U.S. Person Guaranteed by, or Affiliate Conduit of, a U.S. Person	Non-U.S. Person Not Guaranteed by, and Not an Affiliate Conduit of, a U.S. Person
U.S. CFTC-Regulated Swap Entity (including an affiliate of a non-U.S. person)	Margin Rules Apply	Margin Rules Apply	Margin Rules Apply	Margin Rules Apply
Foreign Branch of U.S. Bank that is a CFTC-Regulated Swap Entity	Margin Rules Apply	Substituted Compliance Permitted	Substituted Compliance Permitted	Substituted Compliance Permitted
Non-U.S. CFTC-Regulated Swap Entity (including an affiliate of a U.S. person)	Margin Rules Apply	Substituted Compliance Permitted	Substituted Compliance Permitted	Margin Rules Do Not Apply

apply the margin requirements at the entity level, regardless of whether the counterparty to the swap is a U.S. person, but may allow substituted compliance in certain circumstances. As noted in the CFTC's Proposed Rule, "this approach would be intended to address the concern that the source of the risk to a firm – given that the non-U.S. [Swap Entity] has sufficient contact with the United States to require registration as [a Swap Entity] – is not confined to its uncleared swaps with U.S. counterparties or to its uncleared swaps executed within the United States." A summary of the application of the margin requirements under the Entity-Level Approach, as provided in the CFTC's Proposed Rule, is shown in Table 2.

Prudential Regulators' Approach. Under the Prudential Regulators' Approach, the CFTC would adopt the approach of the Prudential Regulators' Proposed Rule. The Prudential Regulators propose not to assert authority over transactions between a non-U.S. Swap Entity that is not guaranteed by a U.S. person and either a (i) non-U.S. Swap Entity that is not guaranteed by a U.S. person or (ii) a non-U.S. person that is not guaranteed by a U.S. person. The Prudential Regulators' Approach is generally consistent with the Entity-Level Approach described above, except with regard to the application of the margin requirements to certain non-U.S. Swap Entities. In addition, this approach is consistent with the Cross-Border Guidance Approach to margin requirements with respect to transactions between a non-U.S. Swap Entity and a non-U.S. person that is not guaranteed by a U.S. person. However, under the definition of "foreign covered swap entity" in the Prudential Regulators' Proposed Rule, a non-U.S. Swap Entity controlled by a U.S. person would not be a foreign covered swap entity, and thus, would not qualify for the exclusion from the margin requirement. In addition, the Prudential Regulators' Proposed Rule incorporates a "control" test for purposes of determining whether a registered Swap Entity subject to regulation by the Prudential Regulators is not a "foreign" entity.

Prohibited Assets

Both the CFTC's Proposed Rule and the Prudential Regulators' Proposed Rule require that Swap Entities may not collect or post as initial margin any asset that is a security issued by (i) the party providing such asset or an affiliate of that party; or (ii) a bank holding company, a savings and loan holding company, a foreign bank, a depository institution, a market intermediary, a company that would be any of the foregoing if it were organized under the laws of the United States or any State, or an affiliate of any of the foregoing institutions. The CFTC's Proposed Rule, however, further specifies that a CFTC-regulated Swap Entity also may not collect or post as initial margin any asset that is a security issued by "a U.S. government-sponsored enterprise after the termination of capital support or another form of direct financial assistance received from the U.S. government that enables the repayments of the government-sponsored enterprise's eligible securities unless the security" is (i) issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of Treasury; (ii) issued by, or fully guaranteed as to the payment of

TABLE 2:

Counterparty A	Counterparty B	Applicable Margin Requirements
U.S. Swap Entity	U.S. person	U.S. Margin Requirements (All)
U.S. Swap Entity		U.S. Margin Requirements (All)
		U.S. Margin Requirements (All)
		U.S. Margin Requirements (All)
U.S. Swap Entity	Non-U.S. person not guaranteed by a U.S. person	U.S. (Initial Margin collected by U.S. Swap Entity)
		Substituted Compliance (Initial Margin collected by non-U.S. person not guaranteed by a U.S. person)
		U.S. (Variation Margin)
Non-U.S. Swap Entity guaranteed by a U.S. Person	Non-U.S. person not guaranteed by a U.S. person	U.S. (Initial Margin collected by non-U.S. Swap Entity guaranteed by a U.S. person)
		Substituted Compliance (Initial Margin collected by non-U.S. person not guaranteed by a U.S. person)
		U.S. (Variation Margin)
		Substituted Compliance Permitted (All)
		Substituted Compliance Permitted (All)
		Substituted Compliance Permitted (All)
Non-U.S. Swap Entity not guaranteed by a U.S. Person	Non-U.S. person not registered as a Swap Entity and not guaranteed by a U.S. person	Substituted Compliance Permitted (All)

principal and interest by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to swap dealers subject to regulation by a prudential regulator; or (iii) issued by, or fully guaranteed as to the payment of principal and interest by, the Bank for International Settlements, the International Monetary Fund, or a multilateral development bank.

Coordination of Margin Model Approval

With regard to the approval of margin models, the CFTC's Proposed Rule indicates that it will coordinate with the Prudential Regulators in order to avoid duplicate efforts and to provide expedited approval of margin models that a Prudential Regulator had already approved. For example, if a Prudential Regulator had approved the margin model of a depository institution registered as a Swap Entity, CFTC review of a comparable model used by a non-bank affiliate of the Swap Entity would be streamlined. Further, the CFTC would similarly coordinate with the SEC and foreign regulators with regard to margin model approval, and for CFTC-regulated Swap Entities seeking to use models not approved by these entities, the CFTC anticipates coordinating with the National Futures Association to facilitate approval.

DAVID J. GILBERG and KENNETH M. RAISLER are partners and MEGAN R. O'FLYNN is an associate, all located in the New York office of Sullivan & Cromwell LLP.

CLEARING DERIVATIVE TRANSACTIONS IN THE EU: WHAT YOU NEED TO KNOW

PETER GREEN, JEREMY C. JENNINGS-MARES and LEWIS LEE

THIS ARTICLE EXAMINES RECENT DEVELOPMENTS AFFECTING THE CLEARING REQUIREMENTS FOR COUNTERPARTIES TO CERTAIN OVER THE COUNTER DERIVATIVE TRANSACTIONS UNDER EUROPEAN MARKET INFRASTRUCTURE REGULATIONS.

The European Market Infrastructure Regulations ("EMIR") places a number of obligations on counterparties to over the counter ("OTC") derivative transactions. These include the central clearing of trades deemed to be subject to a 'clearing obligation', trade reporting and other risk-mitigation requirements for uncleared trades (such as portfolio reconciliation and trade collateralization). While the requirements apply mostly to institutions established in the EU, a number of EMIR's provisions (including the clearing obligation) also have extraterritorial effect. As a consequence, certain entities established outside of the EU (so-called 'third-country entities'), may have positive obligations under EMIR, dependent upon what their status would be under EMIR if they were hypothetically established in the EU and upon the extent to which they are either (i) trading with EU counterparties, or (ii) entering into derivatives trades which have a "*direct, substantial and foreseeable*" effect within the EU.[1]

Although EMIR has been in force for over two years, a number of the obligations have been phased in gradually. The reporting requirement, for example, came into effect on February 12, 2014. The clearing requirement, however, has taken longer to implement and confirmation of its effective date for different asset classes and counterparties has remained dependent upon a number of factors, not least of which includes the requirement for the European Securities and Markets Authority ("ESMA") to determine which derivatives trades should, in accordance with EMIR's criteria, be mandatorily clearable.

On July 11, 2014, ESMA published its initial consultation on the clearing of certain OTC credit derivatives (the "CD Consultation").[2] On October 1, 2014, ESMA published its final report covering draft technical standards on the clearing obligation, in respect of Interest Rate OTC Derivatives ("IRS Report").[3] Simultaneously, it published a consultation on the clearing obligation to be applied with respect to foreign exchange non-deliverable forwards ("FX NDF Consultation").[4] Each of these publications sets out the extent to which particular derivatives trades might be appropriate for central clearing, in accordance with the criteria required to be satisfied under Article 5(4) of EMIR (the "Criteria"). For example, consideration is given to, amongst other things, the degree of standardization of contractual terms, the volume and liquidity of the market for such transactions and the availability of relevant pricing information. The publications then go on to state when the applicable clearing obligation might apply and with respect to whom.

INTEREST RATE DERIVATIVES

The IRS Report specifies that the interest rate derivative products available for central clearing fall broadly into four categories:

- Fixed-to-Floating Interest Rate Swaps (plain vanilla IRS);
- Floating-to-Floating Interest Rate Swaps (known as basis swaps);
- Forward Rate Agreements (FRA); and
- Overnight Index Swaps (OIS).

These categories are then further broken down in order to define the applicable class that is subject to the clearing obligation. Characteristics used for this purpose include settlement currency (primarily EUR, GBP, USD and JPY), maturity (e.g., between 28 days and 50 years for a basis swap, or between 3 days and 3 years for an FRA), the existence of any optionality and the notional type (constant or variable).

The draft RTS in the IRS Report set out the complete list of clearable derivative classes in Annex 1 thereto. However, ESMA makes clear that it continues to assess the scope of other interest rate derivatives denominated in non-G4 currencies and that it can "add at any moment classes that were not previously declared to be subject to the clearing obligation."

CREDIT DERIVATIVES

Unlike the clearing of interest rate and foreign exchange derivatives, the market for credit derivatives is typically

[1] An obligation may also arise where it is necessary or appropriate to prevent the evasion of any of the provisions of EMIR.

[2] http://www.esma.europa.eu/system/files/2014-800.pdf.

[3] http://www.esma.europa.eu/system/files/esma-2014-1184_final_report_clearing_obligation_irs.pdf.

[4] http://www.esma.europa.eu/system/files/esma-2014-1185.pdf. It should be noted that separately, ESMA has also consulted on the clearing obligation as it might be applied to credit derivatives.

more bespoke and less standardized. As a consequence, there are fewer transaction types which satisfy the Criteria and therefore lend themselves to clearing. Nevertheless, given that the credit market represented circa $21 trillion in outstanding notional at the end of 2013,[5] ESMA recognizes the significance of the market and the priority need to try and clear such trades where possible. In particular, it proposed in the CD Consultation that the clearing obligation should be applied to trades referencing certain untranched indices, specifically the iTraxx Europe Main Index and the iTraxx Europe Crossover Index. Such trades should reference Series 11 of the relevant index onwards, have a 5 year maturity and settle in EUR. It remains to be seen how (if at all) these conclusions might be amended following publication of ESMA's final report on the clearing of credit derivatives.

FOREIGN EXCHANGE DERIVATIVES

In the FX NDF Consultation, ESMA makes clear that it considers non-deliverable forward transactions ("NDFs") to be cash-settled foreign exchange forward contracts. Such transactions will typically specify an exchange rate against the currency of delivery (the convertible currency),[6] a notional amount of the non-convertible currency and a settlement date. Given the cash-settled nature of these transactions, there is no physical delivery of the designated currency at maturity. Instead, at the time of settlement, spot market exchange rates are compared to forward rates and the trades are cash-settled on a net basis, in the convertible currency, based on the notional amount. Such NDFs are commonly referred to in the context of a particular currency-pair, such as Taiwan Dollar (TWD) / U.S. Dollar (USD) or Brazilian Real (BRL) / U.S. Dollar (USD).

Based on its analysis of the market and the required Criteria, ESMA has provisionally concluded that the following NDF currency pairs should be subject to a clearing obligation (assuming cash settlement in USD with a maturity range between 3 days and 2 years):

- Brazilian Real (BRL) / U.S. Dollar (USD)
- Chilean Peso (CLP) / U.S. Dollar (USD)
- Chinese Yuan (CNY) / U.S. Dollar (USD)
- Colombian Peso (COP) / U.S. Dollar (USD)
- Indonesian Rupiah (IDR) / U.S. Dollar (USD)
- Indian Rupee (INR) / U.S. Dollar (USD)
- Korean Won (KRW) / U.S. Dollar (USD)
- Malaysian Ringgit (MYR) / U.S. Dollar (USD)
- Philippine Peso (PHP) / U.S. Dollar (USD)
- Russian Ruble (RUB) / U.S. Dollar (USD)
- Taiwan Dollar (TWD) / U.S. Dollar (USD)

CATEGORIZATION OF MARKET PARTICIPANTS

Given the details provided with respect to which transactions are likely to become clearable, the next question is *when* this is likely to happen? Since ESMA recognizes that different counterparties are subject to different levels of readiness for central clearing, its preference is to operate a phased-in approach, whereby the largest and most active participants shall be required to centrally clear their derivatives trades first. Accordingly, it has opted to divide market counterparties into four categories as follows:

Category 1 = *Clearing Members.* ESMA regards that Clearing Members are the group of counterparties that should have to clear first, since they are the most active participants and they already have direct access to the CCPs to clear their derivatives.

Category 2 = *Financial Counterparties or Alternative Investment Funds ("AIFs") that are also Non-Financial Counterparties above the clearing threshold* ("NFC+"),[7] which:

- are not Clearing Members satisfying the Category 1 requirements; and
- have an aggregate month-end average notional amount of non-centrally cleared derivatives equal to or greater than, €8 billion.

Category 3 = *Financial Counterparties* or *AIF's that are also NFC+ entities*, which:

- are not Clearing Members satisfying the Category 1 requirements; and
- do not have an aggregate month-end average notional amount of non-centrally cleared derivatives equal to or greater than, €8 billion.

Category 4 = All *NFC+ entities* which are not covered by Categories 1, 2 or 3.

It should be noted that these categories reflect the position as stated in the IRS Report, following ESMA's analysis of the market's response to its proposals. At present, the CD Consultation makes reference to the application of only three phase-in categories, as per the position in the initial IRS consultation (published in July 2014).

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[5] Bank for International Settlements, statistics at December 2013 - http://www.bis.org/statistics/derdetailed.htm.

[6] This is typically USD.

[7] The clearing thresholds refer to thresholds above which EMIR requires that a Non-Financial Counterparty shall be subject to the clearing requirement. They are as follows: 1 billion in gross notional value for OTC credit derivative contracts, €1 billion in gross notional value for OTC equity derivatives, €3 billion in gross notional value for OTC interest rate derivatives, €3 billion in gross notional value for OTC foreign exchange derivatives, €3 billion in gross notional value for OTC commodity derivatives and €3 billion in gross notional value for OTC derivative contracts not otherwise specified. Once an entity breaches the clearing threshold for any one class of derivatives, it is required to centrally clear all classes of derivatives subject to the clearing obligation.

We expect, however, that the phase in of credit derivative clearing will follow the approach described above (as is also the case for foreign exchange derivatives).

CONSIDERATIONS FOR THIRD-COUNTRY ENTITIES

The categorization of entities established in third-countries is exactly the same as it is for EU counterparties. This is because third-country entities are deemed to belong to the category of counterparty to which they *would* belong, *if they were established in the Union.* Essentially, a non-EU entity that is subject to the clearing obligation shall therefore be required to make the following determinations:

- If the relevant entity were 'hypothetically' established in the EU, would it be either a Financial Counterparty or an NFC+?

SINCE ESMA RECOGNIZES THAT DIFFERENT COUNTERPARTIES ARE SUBJECT TO DIFFERENT LEVELS OF READINESS FOR CENTRAL CLEARING, ITS PREFERENCE IS TO OPERATE A PHASED-IN APPROACH, WHEREBY THE LARGEST AND MOST ACTIVE PARTICIPANTS SHALL BE REQUIRED TO CENTRALLY CLEAR THEIR DERIVATIVES TRADES FIRST.

A large number of third-country entities, particularly those which trade derivatives with EU counterparties, have already been asked by such EU counterparties to consider their classification under EMIR, for example, in order for the EU counterparty to work out how often portfolios of non-cleared derivatives need to be reconciled. As a consequence, for many entities, this analysis may not be entirely new. However, entities looking at this for the first time will need to consider a variety of factors, including the nature of their business and the volume of derivatives trades that they enter into.[8]

- Is the relevant entity a direct Clearing Member of a CCP authorized under EMIR?

To fall into Category 1 for *all* classes of derivatives subject to the clearing obligation, an entity only needs to be a Clearing Member (of a CCP that is authorized under EMIR to clear such derivatives) for the purpose of clearing *one* of the classes of derivatives subject to the clearing obligation.

- If the relevant entity were established in the EU, would it be an Alternative Investment Fund (AIF) that qualifies as an NFC+?

An AIF is essentially a collective investment undertaking, including investment compartments thereof, 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. Certain AIFs do not qualify as Financial Counterparties but still trade a high enough volume of OTC derivatives to fall above the clearing threshold for a particular asset class. As a consequence, this may push the relevant counterparty into either Category 2 or 3.

PHASE-IN OF CLEARING OBLIGATION

Given the classification of an entity in accordance with the categorization described above, the phase-in dates for when the clearing obligation comes into effect are as follows:

- Category 1: 6 months after the applicable RTS enters into force;
- Category 2: 12 months after the applicable RTS enters into force;
- Category 3: 18 months after the applicable RTS enters into force; and
- Category 4: 3 years after the IRS RTS enters into force.[9]

COUNTERPARTIES IN TWO DIFFERENT CATEGORIES

Where a contract is entered into between two counterparties included in different categories, then the clearing obligation takes effect on the latest of the two dates. Therefore, in order to know when the clearing obligation will apply in respect of clearable trades entered into between two counterparties, each counterparty must know its own categorization, as well as the categorization of its counterparty.

FRONTLOADING

Article 4(1)(b)(ii) of EMIR provides the primary frontloading obligation. This states that after a CCP has been authorized to clear a particular class of derivative, but before the actual clearing obligation applies to that class of derivatives (the "frontloading period"), all derivatives of that class that are entered into or novated during the

[8] Morrison & Foerster has acted for a significant number of third-country entities in performing this analysis and would be happy to assist if this were required.

[9] The Category 4 phase-in for interest rate swaps is 3 years (or 36 months) from the date the IRS RTS comes into force. Given that the effectiveness of the NDS RTS will follow that date by around three months, there will be a progressive shortening for each future class of derivative to be cleared going forwards, thereby ensuring that the clearing obligation for all classes of derivatives is likely to be fully implemented within 3 years of the IRS RTS coming into force.

frontloading period and have a certain minimum remaining maturity, must be cleared.

The main concern with this obligation from an operational perspective has been that market participants have had no certainty regarding whether or not (or when) a particular derivative that they are about to enter into will become clearable. As a consequence, this has led to enormous pricing difficulties (i.e., should it be priced as a cleared trade or not?). Since a cleared OTC trade has a different collateralization and liability regime to an uncleared OTC trade, it needs to be priced differently.

ESMA was charged with developing regulatory technical standards in relation to the appropriate minimum remaining maturity for contracts to be frontloaded, and in a letter from ESMA to the Commission dated May 8, 2014, ESMA explains that the frontloading period can be subdivided into two categories:

Period A: From the time a CCP is authorized by a competent authority to clear a class of derivatives (and such authorization is notified to ESMA) and the date of publication in the Official Journal of the RTS relating to clearing that class; and

Period B: From the date of publication in the Official Journal of the RTS relating to clearing that class and the date of application of the clearing obligation.

Period A is deemed to be the time of greater concern to market participants, since at that stage, there is no clarity on whether the class of derivatives will be accepted for clearing. In Period B, however, the RTS has been finalized and counterparties will have a date for when the clearing obligation becomes effective (depending on their categorization).

For Period A therefore, ESMA has recommended setting the minimum remaining maturity requirement very high, to ensure that effectively no trades entered into or novated during that period will need to be cleared. For Period B, however, ESMA has recommended a reasonably low level which ensures that only those trades close to expiry (e.g., within 6 months) when the RTS are published will not have to be cleared.

NEXT STEPS

The IRS Report has now been submitted to the European Commission. The Commission has three months within which to adopt the draft RTS in the form of a Commission Regulation. Assuming that the RTS are adopted by the end of the three month period, this means that the first phase of Category 1 clearing obligations will become applicable in mid- 2015.

The CD Consultation closed for comments on September 18, 2014. We await ESMA's final report in this regard. The FX NDF Consultation remains open for comments until November 6, 2014. Once the consultation process for these asset classes has been completed, the technical standards applicable to credit and foreign exchange derivatives will be published in final form and submitted to the European Commission for endorsement. As above, the European Commission will have three months to make its endorsement.

PETER J. GREEN and JEREMY C. JENNINGS -MARES are partners and LEWIS G. LEE is an associate, all located in the London office of Morrison & Foerster (UK) LLP.

CFTC STAFF ISSUES SELF-EXECUTING REGISTRATION RELIEF FOR CERTAIN DELEGATING CPOS

DEBORAH A. MONSON and JEREMY A. LIABO

THIS ARTICLE DISCUSSES THE COMMODITY FUTURES TRADING COMMISSION'S RECENTLY ISSUED LETTER, LETTER NO. 14-126, PROVIDING SELF-EXECUTING REGISTRATION RELIEF TO CERTAIN DELEGATING COMMODITY POOL OPERATORS.

On October 15, 2014, the Commodity Futures Trading Commission ("CFTC") staff issued Letter 14-126 (the "October Letter"), which provides self-executing registration relief to a commodity pool operator ("CPO") of a fund that delegates its rights and obligations as a CPO to another entity that will serve as the registered CPO of the fund, if certain conditions are met. The October Letter replaces CFTC Letter 14-69 (the "May Letter"), which required each CPO to receive its own no-action letter to be able to delegate its CPO functions to a registered CPO. If the conditions of the October Letter are not met, a CPO will still need to obtain its own no-action letter. We recommend that private fund sponsors take this opportunity to review the CPO status of the parties that may be CPOs with respect to the fund (i.e., a fund's general partner, manager, directors and/or trustees), and consider whether the fund can rely on the self-executing relief made available by the October Letter to avoid registration obligations otherwise applicable to each CPO.

BACKGROUND

Historically, the CFTC staff has considered a private fund's general partner, manager, directors or trustees to be the fund's CPO. Accordingly, a fund sponsor that uses special purpose entities to serve as general partners or limited liability company managers of the funds it advises, or that has directors or trustees for its funds, may have multiple CPOs, each of which would be required (absent no-action relief from the CFTC) to register separately as a CPO or claim an applicable exemption. The May Letter established a streamlined process whereby the CFTC staff would grant relief on an expedited basis when certain criteria were met and a form of request was filed. For many, satisfying the criteria under the May Letter proved to be problematic. For instance, affiliated directors often could not use the streamlined process because they are involved in solicitation of investors or in portfolio management for the fund. Other CPOs could not use the streamlined process because they appointed trading advisors with investment management authority over fund assets. In addition, CPOs were reluctant to affirmatively attest that they would maintain the books and records of the fund in accordance with CFTC Rule 1.31 (which contains outdated technical provisions). Moreover, as it turned out, the CFTC staff actually granted only a small number of the requests they received based on the streamlined process.

The October Letter addresses many of the impediments to streamlined relief under the May Letter. Specifically, the October Letter revised the enumerated criteria to allow a CPO to appoint third-party trading advisors, to allow directors to participate in solicitation (as associated persons of the registered CPO) and in portfolio management (as principals or employees of the registered CPO), and to remove the attestation of compliance with Rule 1.31. Significantly, CPOs will no longer be required to submit requests for relief. So long as the criteria enumerated in the October Letter are satisfied, the relief under the October Letter is self-executing.

THE CRITERIA FOR RELIEF

In the October Letter, the CFTC staff set forth specific criteria that must be met to qualify for the self-executing relief. In essence, there must be a legally binding document pursuant to which the delegating CPO has delegated to the designated CPO all of its investment management authority with respect to the fund (the CPO may in turn appoint third-party trading advisors). If a delegating CPO is not an individual, then the legally binding document must require the delegating and designated CPOs to be jointly and severally liable for any violation of the Commodity Exchange Act or the CFTC rules of the other in connection with the fund. Similarly, if a delegating CPO is an individual and is affiliated with the designated CPO, then the legally binding document must require the delegating and designated CPOs to be jointly and severally liable for one another's violations of the Commodity Exchange Act or the CFTC rules with respect to the fund. If a delegating CPO is an individual but is not affiliated with the designated CPO, there is no such requirement. Affiliation for this purpose is based on being a member of management or an employee of the designated CPO (or an affiliate), having substantial beneficial ownership of the designated CPO (or an affiliate), or having an interest or relationship that could interfere with the ability to act independently of management of the designated CPO (or an affiliate).

IN THE OCTOBER LETTER, THE CFTC STAFF SET FORTH SPECIFIC CRITERIA THAT MUST BE MET TO QUALIFY FOR THE SELF-EXECUTING RELIEF.

The delegating CPO must not participate in the solicitation of investors except as an associated person of the registered CPO, and must not manage any property of the fund except as a principal or employee of the designated CPO or of a trading advisor for the fund. There must be a legitimate business purpose for the designated CPO being a separate entity from the delegating CPO. The designated CPO must be registered as a CPO and must maintain the books and records of the delegating CPO with respect to the fund, and the delegating CPO must not be subject to a statutory disqualification under the Commodity Exchange Act. Finally, if neither the delegating CPO nor the designated CPO is an individual, then one such CPO must control, be controlled by, or be under common control with the other CPO (criterion #6).

Many CPOs that did not previously qualify for the streamlined approach under the May Letter will now qualify for the relief under the October Letter. Issues remain, however, including those arising under criterion #6. As a result of criterion #6, unaffiliated entity directors, trustees, general partners or managing members that are delegating CPOs will be required to request no-action relief from the CFTC staff. We understand that the CFTC staff is aware that this issue remains and that the staff may consider addressing it in follow-on guidance or in a rulemaking process.

NEXT STEPS

The October Letter does not affect the validity of any prior staff letter issued with respect to CPO registration relief for a delegating CPO, including any relief granted pursuant to the May Letter. However, the staff will no longer consider requests for relief under the May Letter, including any requests previously submitted that are still pending. If a CPO has not received a delegation no-action letter from the staff, it should consider taking advantage of the relief under the October Letter.

To take advantage of the relief under the October Letter, CPOs should first review the criteria and confirm that the criteria are satisfied. This process would include reviewing the applicable investment management or separate delegation agreements to ensure that they contain provisions addressing the requirements of the October Letter, and amending these agreements as needed. CPOs should also establish a process to make sure that agreements for future funds contain the necessary provisions to meet the criteria and that all agreements are updated as needed to reflect changes, including changes in directors.

A CPO that is unable to qualify for the relief set forth in the October Letter should prepare its own request for delegation no-action relief based on its specific facts and circumstances and submit it to the staff for consideration.

DEBORAH A. MONSON is a partner and JEREMY A. LIABO is an associate, both located in the Chicago office of Ropes & Gray LLP.

IN RECENT NEWS

IRS PROVIDES FATCA-RELATED RELIEF FOR ACCOUNTS OPENED BEFORE JAN. 1, 2015

In a Notice, IRS has announced that it will amend temporary regs issued earlier this year so as to provide relief from withholding from payments to nonresident aliens and foreign corporations, with respect to accounts opened on or after Jul. 1, 2014, and before Jan. 1, 2015. The relief provides coordination with comparable rules under the Foreign Account Tax Compliance Act (FATCA).

Background. Chapter 4 (Code Sec. 1471 through Code Sec. 1474, FATCA) of the Code requires withholding agents to withhold 30% of certain payments to a foreign financial institution (FFI) unless the FFI has entered into a "FFI agreement" with IRS to, among other things, report certain information with respect to U.S. accounts. (The withholding rules are essentially a mechanism to enforce new reporting requirements.) FFIs that have entered into FFI agreements are referred to as "participating FFIs." Chapter 4 also imposes withholding, documentation, and reporting requirements on withholding agents with respect to certain payments made to certain non-financial foreign entities (NFFEs) that do not provide information on their substantial U.S. owners to withholding agents.

In February, 2014, IRS published temporary regs in T.D. 9658 (temporary coordination regs). The temporary coordination regs modify certain provisions of the regs under chapters 3 (withholding on nonresident aliens and foreign corporations) and 61 (information and returns) and section 3406 (backup withholding) to coordinate with the chapter 4 regs. The temporary coordination regs are generally effective for payments made by withholding agents and payors beginning on or after Jul. 1, 2014.

The temporary coordination regs in Reg. § 1.1441-7(b) amend the standards of knowledge regarding the circumstances under which a withholding agent has reason to know that a payee's claim of foreign status is unreliable or incorrect. The temporary coordination regs in Reg. § 1.1441-7T(b)(5) and Reg. § 1.1441-7T(b)(8) modify the circumstances under which a withholding agent, that is described in Reg. § 1.1441-7T(b)(3)(i) (including a financial institution) and that has obtained a withholding certificate or documentary evidence, has reason to know that a claim of foreign status made by a direct account holder is unreliable or incorrect for purposes of chapters 3 and 61. The temporary coordination regs provide additional U.S. indicia that will cause a withholding agent to have reason to know that a claim of foreign status by a direct account holder is unreliable or incorrect for purposes of chapters 3 and 61.

Reg. § 1.1441-7T(b)(3)(ii) provides an exception to these rules for a preexisting obligation if the foreign status of the direct account holder was documented by the withholding agent for purposes of chapter 3 or chapter 61 before Jul. 1, 2014, unless the withholding agent is notified of a change in circumstances with respect to the obligation or, in the case of an individual account holder, reviews documentation that contains a U.S. place of birth.

Reg. § 1.6049-5T(c)(1) provides guidance on a payor's use of documentary evidence with respect to an offshore obligation to establish a payee's foreign status for certain amounts paid outside the U.S. under Reg. § 1.6049-5T(e). Prior to amendment by the temporary coordination regs, an amount was considered paid outside the U.S. under Reg. § 1.6049-5(e) if the payor completed the acts necessary to effect the payment outside the U.S., provided that the payment was not further described in Reg. § 1.6049-5T(e). Reg. § 1.6049-5T(e) describes certain "U.S. tiebacks," which cause a payment not to be treated as an amount paid outside the U.S., such as when a payment is transferred to an account maintained by the payee in the United States or mailed to a U.S. address when certain other conditions apply.

The temporary coordination regs amended Reg. § 1.6049-5T to provide further guidance with respect to when an amount is considered paid outside the U.S. and the types of documentary evidence permitted for establishing a payee's foreign status with respect to certain payments, including the requirements for maintaining such documentation.

In May, 2014, IRS issued Notice 2014-33, 2014-21 IRB 1033, which states IRS's intention to amend the chapter 4 regs to allow a withholding agent or FFI to treat an obligation held by an entity that is issued, opened, or executed on or after Jul. 1, 2014 and before Jan. 1, 2015, as a preexisting obligation described in Reg. § 1.1471-2T(a)(4)(ii), Reg. § 1.1472-1T(b)(2) and Reg. § 1.1471-4(c)(3).

A chapter 4 withholding agent isn't required to withhold on withholdable payments made before Jul. 1, 2016 on preexisting obligations for which a withholding agent doesn't have documentation indicating the payee's status as a nonparticipating FFI. (Reg. § 1.1471-2T(a)(4)(ii)(A).) Comparable rules apply to preexisting obligations held by NFFEs. (Reg. § 1.1472-1T(b)(2))

A participating FFI isn't required to identify and document a preexisting entity account the aggregate balance or value of which is $250,000 or less if no holder of the account that has previously been documented by the FFI as a U.S. person for purposes of chapter 3 or 61, is a specified U.S. person. (Reg. § 1.1471-4(c)(3)(iii)(A))

Notice announces relief for accounts opened before Jan. 1, 2015. In Notice 2014-59, IRS has announced relief with respect to Reg. § 1.1441-7T(b) and Reg. § 1.6049-5T.

Relief with respect to Reg. § 1.1441-7T(b). IRS came to realize that a withholding agent that makes a payment that is subject to withholding under chapter 3 to a new account held by an entity that it treats as a preexisting account under Notice 2014-33 would be required to apply the revised standards of knowledge under Reg. § 1.1441-7(b) when validating a withholding certificate or documentary evidence furnished by the entity to determine whether withholding under chapter 3 applies, even though the withholding agent may have a longer period of time to apply the documentation requirements (including the revised standards of knowledge) under chapter 4 with respect to the same entity.

As a result, IRS intends to modify the revised standards of knowledge in the temporary coordination regs to allow a withholding agent to apply the rules under Reg. § 1.1441-7(b)(5) and Reg. § 1.1441-7(b)(8) as in effect on Apr. 1, 2013 (pre-coordination regs), to accounts opened, and obligations entered into, by an entity, on or after Jul. 1, 2014, and before Jan. 1, 2015. Thus, withholding agents have additional time to apply the new entity account procedures to document a new obligation held by an entity, in coordination with the relief provided by Notice 2014-33.

IRS also took note of the fact that the allowance for preexisting obligations provided in Notice 2014-33 and pre-coordination Reg. § 1.1441-7(b)(3)(ii) would still require a withholding agent to immediately identify a change in circumstances for an entity payee that occurs on any date on or after Jul. 1, 2014, based on the additional U.S. indicia specified in Reg. § 1.1441-7(b). Commentators suggested that, because withholding agents lack existing systems that can identify the new U.S. indicia, additional time should be provided for withholding agents to modify their systems to identify the new U.S. indicia for an existing entity account holder.

So, to coordinate with the revised Reg. § 1.1441-7(b)(5) and Reg. § 1.1441-7(b)(8) applicability date described above, IRS will amend the temporary coordination regs to provide that, with respect to an obligation held by an entity, a withholding agent will not be required to treat the additional U.S. indicia specified in Reg. § 1.1441-7(b) as a change in circumstances under Reg. § 1.1441-1(e)(4)(ii)(D) before Jan. 1, 2015.

These amendments apply to withholding agents and FFIs for purposes of determining a payee's or account holder's foreign status for chapter 4 purposes by cross-reference to pre-coordination Reg. § 1.1441-7(b) in Reg. § 1.1471-3(e)(4) and are available only with respect to obligations held by entities.

Relief with respect to Reg. § 1.6049-5T. To allow payors additional time to modify their systems to implement the revised requirements of Reg. § 1.6049-5T(c)(1), IRS will modify the temporary coordination regs to allow a payor to continue to use, for accounts opened on or after Jul. 1, 2014, and before Jan. 1, 2015, the rules regarding the use of documentary evidence under Reg. § 1.6049-5(c)(1) and Reg. § 1.6049-5(c)(4) as in effect Apr. 1, 2013 ("prior Reg. § 1.6049-5(c)"), instead of the new rules regarding documentary evidence for offshore obligations under Reg. § 1.6049-5T(c)(1) and Reg. § 1.6049-5T(c)(4) of the temporary coordination regs. For consistency, a payor that applies prior Reg. § 1.6049-5(c) to an account or obligation will also be required to apply Reg. § 1.1441-6(c)(2) (to the extent applicable) and Reg. § 1.6049-5(e) as in effect Apr. 1, 2013, with respect to the account or obligation.

Taxpayer's options in applying Notice. As under Notice 2014-33, the relief provided by this notice may be used with respect to all accounts and obligations to which the relief applies, or separately with respect to any such account or clearly identified group of such accounts (for example, by line of business).

Effective date. Prior to the issuance of the amendments to the regs, taxpayers may rely on Notice 2014-59 regarding the modified applicability dates.