WILMER CUTLER PICKERING
HALE AND DORR LLP

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SEC Recharacterizes Swap Transactions As "Sham Loans": A Potential Regulatory Fall-Out from the Market Timing Investigations

On July 20, 2005, the Securities and Exchange Commission (SEC) announced a settled administrative proceeding against Canadian Imperial Bank of Commerce's (CIBC) broker-dealer and financing subsidiaries for their roles in facilitating deceptive market timing and late trading of mutual funds by certain hedge fund customers.[1] The SEC ordered the subsidiaries, CIBC World Markets Corp. (World Markets), a New York-based broker-dealer, and Canadian Imperial Holdings Inc. (CIHI), a New York-based corporation that is not registered with the SEC, to pay $125 million, consisting of $100 million in disgorgement and $25 million in penalties. According to the Settlement Order, CIHI and World Markets engaged in three types of conduct that violated the federal securities laws: (1) CIHI financed hedge fund customers while knowing they would use the leverage to late trade and deceptively market time mutual funds; (2) CIHI provided, and World Markets arranged, improper financing for market timing hedge fund customers in violation of the margin and extension of credit requirements; and (3) a team of World Markets registered representatives enabled numerous customers to late trade and deceptively market time mutual funds. This settlement was reached in conjunction with the New York Attorney General's Office (NYAG), which announced a parallel settlement on July 20, 2005.[2]

In many respects, the SEC's settlement with CIBC's subsidiaries is not remarkable, and the misconduct involving deceptive market timing and late trading of mutual funds is an all-too-familiar story.[3] However,

1. In the Matter of Canadian Imperial Holdings Inc. and CIBC World Markets Corp., Exchange Act Release No. 52063 (July 20, 2005), *available at* http://www.sec.gov/litigation/admin/33-8592.pdf ("Settlement Order").

2. *See* Press Release, Office of New York State Attorney General Eliot Spitzer, CIBC Settles Market Timing Investigation: Agrees to Pay $125 Million in Restitution and Penalties (July 20, 2005), *available at* http://www.oag.state.ny.us/press/2005/jul/jul20a_05.html. The NYAG's complaint is available at http://www.oag.state.ny.us/press/2005/jul/CIBC%20Complaint.pdf ("NYAG Complaint").

3. Generally, "market timing" includes "(a) frequent buying and selling of shares of the same mutual fund or (b) buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing." Settlement Order, at ¶ 8. "Late trading" refers to "the practice of placing orders to buy or sell mutual fund shares after the time as of which a mutual fund has calculated its NAV (usually as of the close of trading at 4:00 p.m. ET), but receiving the price based on the prior NAV already determined as of 4:00 p.m." Settlement Order, at ¶ 10.

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the Settlement Order is significant in that the SEC—without explanation or analysis—also recharacterized certain total return swaps (TRSs) that CIHI entered into with its hedge fund customers as "improper extensions of credit" that violated federal margin requirements. As described by Mark K. Schonfeld, Regional Director of the SEC's Northeast Regional Office, "CIHI's swap transactions were little more than sham loans designed to evade the margin regulations. Today's Order demonstrates that financial institutions cannot use structured transactions to flout the law."[4]

Below is a more detailed description of CIHI's swap transactions, an overview of the status of TRSs generally, and a discussion of the possible legal bases for recharacterizing CIHI's transactions as "sham loans." Although the Settlement Order does not include any specifics about the terms of a particular TRS, it appears that CIHI's swap transactions involved enough structural anomalies to raise serious questions about their status under the federal margin regulations. This Settlement Order should serve as a reminder for securities lawyers and compliance professionals that they must look beyond a transaction's labeling, and should not assume that form will control its characterization.

I. Description of the "Improper Financing Arrangement"

According to the Settlement Order, CIHI financed market timing hedge funds through the use of transactions that were labeled as TRSs but, in reality, were extensions of credit to the hedge fund customers. As described in the Settlement Order:

> Under the TRSs, both CIHI and the hedge fund would contribute money to a managed account, usually in ratios of 4:1 leverage, although in some instances this ratio was even higher. CIHI then placed the funds it contributed (i.e., 80% of the funds) ("the floating notional") as well as the funds the hedge fund customer contributed (i.e., 20% of the funds), in an account at a broker-dealer or trust company ("the managed account"). (The total amount of funds that CIHI and the customer contributed was known as the "total notional.") Although the managed accounts were in CIHI's name, and CIHI retained the power to liquidate the shares at any time, the hedge fund customer selected an investment manager to make all trading decisions. The funds in the managed accounts were invested in mutual funds with the purpose of timing those funds. . . . The hedge fund obtained all gains made by trading in the managed account, and the hedge fund also was required to pay for all trading losses. In exchange, the hedge fund paid CIHI LIBOR (e.g., interest) plus 95-205 basis points on the funds that CIHI contributed to the managed account.[5]

The NYAG Complaint provides some more information regarding the nature of the financing arrangements between CIHI and the hedge funds. It notes that the arrangements were structured in two parts. First, CIHI and the hedge fund opened a managed account in CIHI's name, each depositing cash or securities into the account. Next, they entered into a contractual agreement whereby the hedge fund received all of the profits earned in the account, in return for paying CIHI a fixed fee based on the amount of cash or securities that CIHI deposited into the account. According to the NYAG Complaint, CIHI's contributions to the managed account (which were funded by CIBC) were effectively collateralized

4. SEC Press Release No. 2005-103, Settled Administrative Proceeding Against Canadian Imperial Bank of Commerce Subsidiaries (July 20, 2005), *available at* http://www.sec.gov/news/press/2005-103.htm ("SEC Press Release").

5. Settlement Order, at ¶ 12.

by the mutual fund investments in the account, which it legally owned:

> CIBC and the hedge fund would then deposit cash or securities into the account according to a leverage ratio. For example, if the amount of the financing provided was $75 million and the leverage ratio was 3 to 1, the hedge fund would deposit $25 million and CIBC would deposit $75 million. . . . The risk to CIBC's hypothetical $75 million was *de minimis*. Before CIHI suffered any losses of its "collateral," $25 million in market timing losses would have to be sustained.[6]

Because CIHI did not treat this arrangement as an extension of credit to the hedge funds for the purpose of purchasing or carrying mutual funds, it did not collect the margin required under federal margin regulations.[7] As such, the SEC found that CIHI violated Section 7(d) of the Securities Exchange Act of 1934, as amended (Exchange Act) and Regulation U promulgated by the Federal Reserve Board (FRB), which limit the credit that non-broker-dealer lenders may extend to finance the purchase or carrying by customers of publicly traded equity securities where the credit is collateralized by those securities.[8] In addition, because World Markets helped arrange this financing that exceeded the leverage restrictions imposed by Regulation U, the SEC found that it violated Section 7(c) of the Exchange Act and Regulation T promulgated by the FRB.[9] Further, because World Markets effected transactions in mutual fund shares for hedge funds in connection with which it arranged this financing, World Markets violated Section 11(d) of the Exchange Act, which restricts credit extended in connection with securities underwritings.[10]

6. NYAG Complaint, at ¶¶ 61-63. As described in the NYAG Complaint, such a loss was "highly unlikely" because, among other things, CIHI had an absolute right to terminate the arrangement when the value of the hedge fund's investment fell to 40% or less of the initial amount deposited by the hedge fund (i.e., the $25 million in the above hypothetical). Also, although the hedge fund directed and controlled the mutual fund investments in the managed account, CIHI imposed diversification requirements and concentration limits. *See id.* at ¶ 63.

7. Currently, the maximum loan value of margin stock under Regulation U, which applies to banks and non-broker-dealer lenders, is 50% of the current market value of the security. Under Regulation T, which applies to broker-dealers, the required margin for a long position in a margin equity security is 50% of the current market value of the security or the percentage set by the regulatory authority where the trade occurred, whichever greater. In addition to Regulation T's required initial margin, NYSE Rule 431 and NASD Rule 2520 impose maintenance margin requirements on broker-dealers to reflect changes in the value of securities positions in their customers' accounts.

8. Section 221.3(a)(1) of Regulation U generally provides that no lender may extend any purpose credit, secured directly or indirectly by margin stock, in an amount that exceeds the maximum loan value of the collateral securing the credit. "Purpose credit" means "any credit for the purpose, whether immediate, incidental, or ultimate, of buying or carrying margin stock." 12 C.F.R. § 221.2. "Carrying" credit means "credit that enables a customer to maintain, reduce or retire indebtedness originally incurred to purchase a security that is currently a margin stock." 12 C.F.R. § 221.2. "Margin stock" includes mutual funds. *See* 12 C.F.R. § 221.2. Unlike Regulation T, which covers all securities credit extended or arranged by broker-dealers, Regulation U only limits credit extended or arranged by covered lenders to buy or carry "margin stock" that is secured, directly or indirectly, by "margin stock."

9. *See* 12 C.F.R. § 220.3. Further, Regulation X makes the lender's violation of Regulation T or U a violation by the borrower, if the borrower willfully causes the lender's violation. *See* CHARLES F. RECHLIN, SECURITIES CREDIT REGULATION § 10:2, at 10-4 (2d ed. 2003).

10. Because open-ended mutual fund shares are continuously in distribution, they are considered a "new issue." Rule 11d1-2 allows a broker-dealer to extend, maintain or arrange for the extension or maintenance of credit on mutual fund shares if the customer has owned the security for at least thirty days. In World Markets' case, however, it arranged for the extension of credit to customers that had held the mutual fund shares for less than thirty days.

II. Overview of TRSs Generally and the Status of Swaps Under the Exchange Act

Before exploring the SEC's possible rationale for recharacterizing CIHI's arrangements as "extensions of credit," it is helpful to provide some background regarding TRSs generally, and their treatment under the Exchange Act. In a typical TRS, one party (i.e., the total return payer) transfers the total economic performance of a reference asset (e.g., an equity security) to the other party (i.e., the total return receiver). Total economic performance includes income from interest and fees, gains or losses from market movements, and credit losses. In return, the total return payer receives a specified fixed or floating cash flow that is not related to the creditworthiness of the reference asset. The total return receiver assumes the entire economic exposure—that is, both market exposure to the reference asset and counterparty credit exposure. The total return payer—frequently an owner of the reference asset—gives up economic exposure to the performance of the reference asset and, in return, takes on counterparty credit exposure.[11]

TRSs are commonly used for a variety of purposes. For example, a party may take a "long" position in an equity swap, as opposed to buying the underlying reference asset directly, because the party is unable to make a direct investment in that stock (e.g., as a result of ownership restrictions) or because it may obtain greater leverage or more advantageous tax treatment by having an ownership interest in the swap, as opposed to the underlying security. Conversely, a "short" equity swap position may be used to hedge an existing long position in the underlying reference asset (or a related security or position). These purposes are perfectly permissible, and the SEC has long-recognized that swaps and other OTC derivative instruments "are important financial management tools that, in many respects, reflect the unique strength and innovation of American capital markets."[12]

Recognizing the important role that swaps play and the need for regulatory flexibility with respect to these instruments, Congress specifically excluded certain swaps from the definition of "security" in the federal securities laws when it passed the Commodity Futures Modernization Act of 2000 (CFMA).[13] Prior to the enactment of the CFMA, the status of security-based swap agreements and similar derivatives under the federal securities laws was subject to some uncertainty. In part to eliminate such legal uncertainty, Congress adopted Section 303 of the CFMA, which provides that the definition of "security" in the Exchange Act does *not* include any "security-based swap agreement" or "non-security based swap agreement," as those

11. International Swaps and Derivatives Association, Inc., Product Descriptions and Frequently Asked Questions, *available at* http://www.isda.org.

12. Annette L. Nazareth, Director, Division of Market Regulation, Testimony Before the Senate Committee on Agriculture, Nutrition and Forestry, Regarding the Report to Congress on Over-The-Counter Derivatives Markets and the Commodity Exchange Act by the President's Working Group on Financial Markets (Feb. 10, 2000), *available at* http://www.sec.gov/news/testimony/tsty2999.htm.

13. Pub. L. 106-554, 114 Stat. 2763. *See* Section 3A(b)(1) of the Exchange Act (excluding "security-based swap agreements" from the definition of "security"); and Section 3A(a) of the Exchange Act (excluding "non-security-based swap agreements" from the definition of "security"). *See also* Section 3(a)(10) of the Exchange Act (definition of "security"). The exclusion from the definition of security for qualifying swap agreements does not apply to the Investment Company Act of 1940, as amended or the Investment Advisers Act of 1940, as amended.

terms are defined in the CFMA.[14] The CFMA, thus, effectively carves out swap agreements meeting these definitions—including qualifying TRSs—from the requirements of the Exchange Act. As a general matter, then, TRSs that do *not* meet the definition of securities under the Exchange Act should *not* be covered by the Exchange Act's margin regulations.[15]

III. Possible Bases for Recharacterizing the Transactions as "Sham Loans"

The TRS transactions described in the Settlement Order appear to have included unconventional features, and there are key distinctions between these transactions and a typical TRS, which may have led to the SEC's view that these were sham loans. First, CIHI's TRSs required the creation of managed accounts or separate investment vehicles into which both CIHI and the swap counterparty (a hedge fund) contributed funds. The purported TRS, then, was *not* a mere swap transaction (as described above), but rather an agreement by CIHI and the swap counterparty to establish what was essentially a joint venture arrangement, in which the swap counterparty would obtain 100% of all gains made by trading in the account, and would be required to pay for all of the trading losses. In return for CIHI's contributions to the joint venture, the swap counterparty agreed to pay CIHI a fixed funding fee.

Second, while it may be common practice for a swap dealer, such as CIHI, to engage in contemporaneous purchases (or sales) of reference assets to hedge its exposure under the swap, the purchases and sales of mutual funds in the managed accounts or separate investment vehicles cannot reasonably be characterized as typical swap hedges because CIHI did not control or direct the mutual fund investments in the managed accounts or separate investment vehicles. Instead, the swap counterparty controlled and directed such investments by selecting the investment manager for the managed accounts or separate investment vehicles.[16]

Although the Settlement Order does not explain the SEC's likely bases for recharacterizing the TRSs as extensions of credit, we believe the staff viewed CIHI's contributions to the managed accounts and separate investment vehicles (whose trading profits were then "swapped" in exchange for a funding fee) as the "extensions of credit"—and not the TRSs more broadly. This view is consistent with the FRB's interpretations and guidance regarding the meaning of an "extension of credit" under Regulations T and U.[17] In that regard, the FRB staff has addressed the issue of whether a

14. To qualify as a "swap agreement" under the CFMA, the transaction generally must be between "eligible contract participants," as that term is defined in the Commodity Exchange Act, and its material terms must be subject to individual negotiation. Notably, a "swap agreement" excludes certain arrangements, including: (1) an option on a security, certificate of deposit, or group or index of securities; (2) exchange-traded options relating to foreign currencies; and (3) transactions providing for the purchase or sale of one or more securities on a fixed or contingent basis (subject to certain exceptions).

15. The CFMA, however, subjects "security-based swap agreements" to certain anti-fraud and anti-manipulation provisions of the Exchange Act.

16. Neither the Settlement Order nor the NYAG Complaint discusses how the investment manager was compensated for its investment advice (that is, the purchases and sales of mutual fund shares as part of the market timing strategy). Presumably, the investment manager would have received no compensation from CIHI to the extent it was affiliated with the swap counterparty (i.e., the general partner of the hedge fund).

17. Neither the Exchange Act nor Regulations T or U define the phrase "extension of credit." However, the FRB has provided guidance regarding the meaning of this phrase, in a variety of contexts, through FRB staff opinions and interpretations.

trading account is a disguised joint venture involving an extension of credit.[18]

For example, in a 1969 interpretation, the FRB determined that an arrangement between an individual and a corporation involving capital contributions disproportionate to the rights to participate in the profits and losses amounted to a joint venture arrangement and an extension of credit by the corporation.[19] The joint venture, formed to invest in margin stock, involved capital contributions by the individual and the corporation of 20% and 80%, respectively, with the corporation receiving a fixed return plus 20% of any gains and bearing 20% of the losses, while the individual would receive 80% of any gains and bear 80% of the losses. Also, the corporation had the right to liquidate the joint venture's portfolio if losses equaled or exceeded the individual's 20% contribution. The corporation held the securities, and upon termination of the venture, the assets would first be applied to repayment of capital contributions.

In concluding that the arrangement involved an extension of credit by the corporation to the individual, the FRB reasoned that:

> The incidents of the [arrangement] closely parallel those of an extension of margin credit, with the corporation as lender and the individual as borrower. The corporation supplies 80 percent of the purchase price of securities in exchange for a net return of 8 percent of the amount advanced plus 20 percent of any gain. Like a lender of securities credit, the corporation is insulated against loss by retaining the right to liquidate the collateral before the securities decline in price below the amount of its contribution. Conversely, the individual—like a customer who borrows to purchase securities—puts up only 20 percent of their cost, is entitled to the principal portion of any appreciation in their value, bears the principal risk of loss should that value decline, and does not stand to gain or lose except through a change in value of the securities purchased.
>
> The Board is of the opinion that where the right of an individual to share in profits and losses of such a joint venture is disproportionate to his contribution to the venture—(1) the joint venture involves an extension of credit by the corporation to the individual; (2) the extension of credit is to purchase or carry margin stock, and is collateralized by such margin stock; and (3) if the corporation is not a broker or dealer subject to Regulation T, the credit is of the kind described by [Regulation U].[20]

In CIHI's case, the managed accounts and separate investment vehicles had many of the characteristics of the joint venture described above. In particular, they involved the right of a person (the hedge fund) to share in profits and losses that were disproportionate to its contribution to the managed account or separate investment vehicle. Also, like a lender of securities credit, CIHI was insulated against loss by retaining the right to liquidate the mutual funds in the account. Conversely, the hedge fund, like a customer who borrows to purchase securities, put up only 20% of the mutual funds' cost, was entitled to the principal portion of any appreciation in their value, bore the principal risk of loss should that value decline, and did not stand to gain or lose except through a change in value of the securities that were purchased or sold, at its direction.

18. According to the FRB staff, "The relationship of joint venture is created when two or more persons combine their money, property or time in the conduct of some particular line of trade or some particular business and agree to share jointly, or in proportion to capital contributed, the profits and losses of the undertaking." Board Interpretation of June 10, 1969, FRRS 5-819.

19. *See id.*

20. *Id.*

It thus seems likely that the SEC regarded CIHI's contribution to the managed accounts and separate investment vehicles as extensions of credit, consistent with the FRB's interpretive guidance described above.[21] This would mean, then, that conventional TRSs on reference assets that do not require the creation of managed accounts or separate investment vehicles would not entail similar risks of recharacterization.

IV. Conclusion

In sum, the circumstances surrounding CIHI's TRSs were highly unusual, and we do not believe the Settlement Order stands for the broader proposition that all TRSs that are designed to enhance leverage should be recharacterized as sham loans.[22] Instead, we believe the better view is that those TRSs premised on the creation of a managed account or separate investment vehicle of the type detailed in the Settlement Order may run the risk of recharacterization as extensions of credit. Specifically, when the TRS can be viewed as an allocation of profits and losses in a manner disproportionate to each party's monetary contribution, then there is a risk the SEC will view the transaction as involving a loan along the lines of the traditional joint venture analysis, notwithstanding the CFMA and the presence of a TRS. To that end, this settlement is an important reminder that securities lawyers and compliance professionals should be wary of arrangements that are marketed or labeled as TRSs or other swap transactions, but contain elements that seem at odds with a typical swap transaction. Such anomalous arrangements may raise concerns about proper characterization.

21. The FRB's conclusion in this interpretation is consistent with the joint venture provision of Section 220.4(b) of Regulation T, which provides that "any interest of [a] creditor in [a] joint account in excess of the interest which the creditor would have on the basis of its right to share in the profits shall be treated as an extension of credit to the joint account." 12 C.F.R. § 220.4(b)(6). *See also* Staff Opinion of December 17, 1987, FRRS 5-621.4 (finding an extension of credit for purposes of Regulation T where a broker-dealer and its customer invested an equal amount of money in a partnership, but the customer was entitled to 80% of the profits, while the broker-dealer only received 20%).

22. It is important to note, however, that certain statements by the SEC staff to the public media regarding CIHI's transactions suggest that an instrument such as a TRS or other structured product may be a "sham" if the parties designed the transaction to avoid certain regulatory requirements: "CIHI's swap transactions were . . . sham loans designed to evade the margin regulations. Today's Order demonstrates that financial institutions cannot use structured transactions to flout the law." SEC Press Release.

If you would like additional information, please contact any of the attorneys below.

Washington:

Brandon Becker
202 663 6979
brandon.becker@wilmerhale.com

Soo Yim
202 663 6958
soo.yim@wilmerhale.com

Stephanie Nicolas
202 663 6825
stephanie.nicolas@wilmerhale.com

New York:

Bruce Newman
212 230 8835
bruce.newman@wilmerhale.com