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Funds Talk

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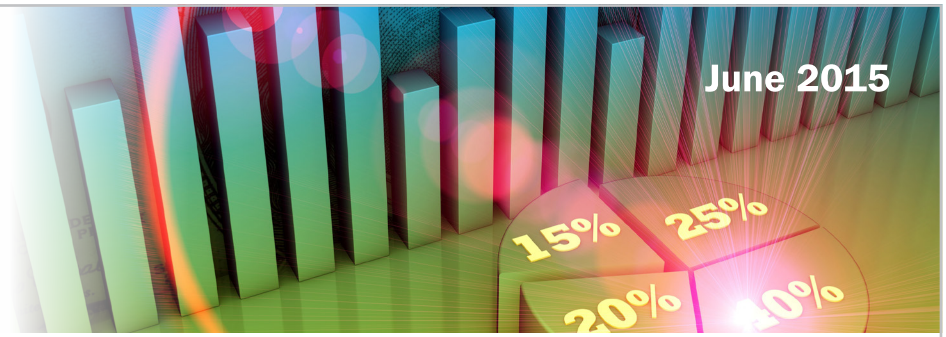

Kramer Levin's ***Funds Talk*** provides legal commentary on the news and events that matter most to alternative asset managers and funds.

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Editorial Team

Mergers and Acquisitions


Ernest S. Wechsler
ewechsler@kramerlevin.com | 212.715.9211

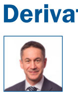
Securitization


Gilbert K.S. Liu
gliu@kramerlevin.com | 212.715.9460

Bankruptcy


Thomas T. Janover
tjanover@kramerlevin.com | 212.715.9186

Derivatives


Fabien Carruzzo
fcarruzzo@kramerlevin.com | 212.715.9203

Insurance


Daniel A. Rabinowitz
drabinowitz@kramerlevin.com | 212.715.9378

Employment


Robert N. Holtzman
rholtzman@kramerlevin.com | 212.715.9513

ISDA Resolution Stay Protocol And Suspension of Early Termination Rights — A Buy-Side Market Perspective

When the International Swaps and Derivatives Association (ISDA) released the 2014 Resolution Stay Protocol, it marked a seismic shift in the rules surrounding early termination rights in the $700-trillion swaps market. ISDA has touted the protocol as "a major component of a regulatory and industry initiative to address the too-big-to-fail issue by improving the effectiveness of cross-border resolution actions against a large bank." However, as significant a change as this was, it may be only the beginning.

The first section of the protocol — which ensures that cross-border counterparties are bound by pre-existing stay provisions of a foreign special resolution regime (SRR), even if the counterparties would normally be exempt due to the jurisdictional limitations of the SRR — hasn't faced much opposition. In contrast, the second section — which seeks to prevent instability and promote orderly unwinds by providing for a temporary suspension or, in certain instances, the elimination of early termination rights arising from a counterparty's affiliate entering insolvency proceedings under certain U.S. resolution regimes — is much more controversial.

And although momentous, the protocol, which came into effect at the start of 2015, initially applied only to 18 large banks, their affiliates and a small number of other significantly important financial institutions deemed "too big to fail." There are signs, however, that these institutions will be getting company.

While buy-side market players aren't covered by the protocol at this time, it's expected they'll be wrapped into the regime in the near future and may lose the benefit of negotiated early termination rights as a result.

U.S. regulators are reportedly considering a rule that would block banks from trading with firms that haven't also signed on to the changes, which would effectively force private fund managers to work within the protocol or risk becoming marginalized.

However, buy-side market participants won't take these changes lying down. The buy-side is expected to fight back, particularly given the facts that (i) changes to bilaterally negotiated contractual termination rights might be imposed via regulation (and the protocol), as opposed to an act of Congress, and (ii) such changes may apply retroactively and may cover previously negotiated agreements and existing transactions.

In addition to over-the-counter swaps, repurchase agreements and securities-lending agreements are also now beginning to face heightened consideration from global regulators and could be incorporated in some form before the end of 2015. The International Securities Lending Association, the International Capital Market Association and the Securities Industry and Financial Markets Association are all expected to be part of that process.

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Despite industry resistance to some aspects of the added regulatory requirements, regulators believe the end objective – the ability to safely guide a major financial institution through failure without resorting to taxpayer bailouts or economic catastrophe – is being realized. FDIC chairman Martin Gruenberg has observed that a Lehman Brothers-type collapse is less likely now than it was in 2008, thanks to U.S. regulators' new powers to impose structural changes on banks, their ability to seize and dismantle failing firms, and improved global regulatory coordination.

However, the possibility of a further extension of such oversight into previously uncharted territory will require ongoing scrutiny. Buy-side market participants will need to coordinate and collaborate to effectively express their concerns to regulators and ensure that new regulations are balanced. They will also need to understand how their previously negotiated early termination rights are affected and make necessary adjustments to their agreements based on their risk appetite. ■

IRS Attempts to Clarify Offshore Insurance Regulations on 'Passive' Income

The Internal Revenue Service issued proposed regulations in April concerning "passive foreign investment companies," or PFICs, that could affect U.S. private funds' use of certain offshore insurance strategies, such as proprietary reinsurers, captives, insurance-linked securities and sidecars.

The notice of proposed rulemaking states that Treasury and the IRS are "aware of situations in which a hedge fund establishes a purported foreign reinsurance company in order to defer and reduce the tax that otherwise would be due with respect to investment income," and that such companies may constitute PFICs rather than bona fide insurers, which can qualify for more favorable tax treatment.

Under the Internal Revenue Code, a foreign corporation whose "passive" income and/or assets exceed certain thresholds is characterized as a PFIC. U.S. shareholders of a PFIC must elect to include in income each year their pro rata shares of the PFIC's income or suffer adverse consequences upon the receipt of distributions on a sale.

Excluded from "passive" income, however, is income "derived in the active conduct of an insurance business." Because insurers earn income not only from underwriting gains but also from investment income, classifying investment income as income "derived in the active conduct of an insurance business" can be elusive in this context but also critical to determining tax status, and the proposed regulations attempt to provide guidance on this issue.

One issue raised by the proposed rules is the cross-reference to regulations issued under Section 367 of the Code to determine whether an insurance business is actively conducted. While the Section 367 regulations prescribe a facts and circumstances analysis, they also provide that in general, to determine whether an insurance business is actively conducted, the officers and employees of the corporation or of related entities must carry out substantial managerial and operation activities. The proposed offshore insurance company rules modify this "active conduct" test to exclude the activities of officers and employees of related entities.

It is to be hoped that in the public comment process, a more sensible basis is arrived at for determining when investment income is insurance-related or not.

This exclusion is significant for captives and other special-purpose insurers that typically conduct their businesses through service providers. By disregarding the activities of service providers, it becomes much more difficult for these insurers to demonstrate "active conduct of an insurance business." Even if the related entity exclusion is retained in the final regulations, it is hoped that the IRS would consider, as part of its "facts and circumstances" test for active businesses, the substantive commercial activities involved (issuing policies, paying claims, etc.) and not merely the formalities of which entity employs the individuals conducting such activities.

In addition, and somewhat more troubling, the proposed regulations provide that the concept of "insurance business" includes investment activities that are "required to support" or "substantially related to" the risks covered by the insurer. Investment activities that qualify under this standard, according to the proposed rule, are those that generate income from assets "held ... to meet obligations" under insurance contracts.

This formulation raises at least two issues.

In its assumption that some "portion" of assets are necessarily held to "meet [policy] obligations," the proposed rule ostensibly focuses on the use of assets, but in effect hinges instead on how liabilities are determined and classified. This is a somewhat different question. Insurer liabilities such as losses on open claims, incurred but not reported losses (IBNR), loss adjustment expense (LAE) and unearned premium reserves are mainly functions of actuarial judgment; the amount of assets "held" to "meet" these is less a question of how the insurer's assets are deployed and more a question of the risk profile of the insurance company's book of business.

Second, to illustrate a possible standard for determining "assets held to meet obligations," the notice of proposed rulemaking suggests that "assets held to meet obligations" could comprise those assets that "do not exceed a specified percentage" of insurance reserves. In a solvent insurance company, assets will typically exceed total reserves, so it would seem as though whatever the specified percentage is (even 100%), it is that amount of "insurance liabilities" that would essentially be the proxy for the assets that the IRS deems insurance-related. Of course, the portion of assets that exceeds the specified portion of reserves (such as the remaining portion of reserves, or surplus or capital) is also invested, and there is nothing about this investment activity that is qualitatively different from that associated with the "specified percentage" assets. It is to be hoped that in the public comment process, a more sensible basis is arrived at for determining when investment income is insurance-related or not.

Treasury is seeking public comment on the proposal before implementing a final rule, with a July 23 deadline for submissions. One captive-insurance trade organization has already commented. Funds navigating offshore insurance strategies, as well as the insurance sector itself, anxiously await the outcome. ■

Whistleblower Warning: SEC Becomes Latest Agency To Attack Restrictive Language in Confidentiality Agreements

The SEC embarked on a precedent-setting course in April when it announced its first enforcement action against a company for using "improperly restrictive language in confidentiality agreements." Following an investigation of Houston-based technology and engineering giant KBR, the regulator and the company agreed to a $130,000 penalty for violating whistleblower protection Rule 21F-17, promulgated under the Dodd-Frank Act, which prohibits impeding an individual from communicating with SEC staff about possible securities law violations.

Earlier the same month, the SEC awarded $600,000 to a whistleblower who provided information resulting in a successful enforcement action against Chicago-based Paradigm Capital Management, which settled charges that it retaliated against the employee for reporting violations. Taken together with the latest action against KBR, this signals a broadening of the SEC's efforts toward a proactive approach that seeks to foster an environment in which whistleblowers are not discouraged from reporting violations.

Specifically, the regulator highlighted a requirement in KBR's agreement that employees notify the company before reporting to the SEC, a provision it said would stifle whistleblowers. "We will vigorously enforce this provision," said Andrew J. Ceresney, director of the Division of Enforcement.

The SEC's action should come as no surprise. FINRA issued a regulatory notice in October 2014 reminding companies to avoid such restrictive language, particularly in settlement agreements with registered persons, while the EEOC has taken an aggressive stance in asserting claims based on employers' use of confidentiality agreements.

For its part, KBR said it agreed to amicably resolve the matter and intended for its confidentiality agreements to be used "only to protect the integrity and confidentiality of its internal, privileged investigations – as has been recognized by the U.S. Court of Appeals." The company, which neither admitted nor denied the charge, also emphasized that it never prevented anyone from reporting wrongdoing to the SEC, or took any action to enforce the agreement.

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The regulatory action underlines the need for companies to incorporate into agreements containing confidentiality or nondisclosure provisions carve-outs explicitly preserving the ability of potential whistleblowers to disclose information to the SEC, FINRA, and other governmental agencies and self-regulatory organizations. ■

Acceptance of Representations and Warranties Insurance Spreads as Its Popularity Keeps Growing

Middle-market M&A deal professionals are using representations and warranties insurance at an unprecedented pace. The growth in the product's use is astonishing. One major insurance company reports that 2014 premium volume for representations and warranties insurance was well in excess of double the premiums for 2013. What are the key drivers behind this growth?

1. Middle-market M&A activity is up. The acquisition market is very active. Auctions are robust and competitive, especially for quality companies with the proven ability to generate earnings consistently. Sellers are commanding favorable terms of sale, including limited or no post-closing recourse for breach of representations and warranties by the seller. Sellers are motivated to exit the investment cleanly without lingering post-closing liability, which enables sellers to maximize receipt of sales proceeds and distributions to investors or to put the sales proceeds to work elsewhere. Buyers that are unwilling to accept this risk profile are turning to representations and warranties insurance to protect themselves against a seller's breach of representation or warranty in the acquisition agreement. Representations and warranties insurance policies enable buyers to present competitive bids in auctions by offering packages that provide for limited or no post-closing recourse against sellers for breach of representation or warranty.

2. Market acceptance of representations and warranties insurance is on the rise. The M&A market has just recently fully embraced representations and warranties insurance as a valid and powerful M&A tool, particularly in the middle market. Ten years ago few M&A professionals had heard of the policies; five years ago many professionals had a vague sense of the policies but did not feel comfortable using them in their M&A deals. Now M&A deal professionals are much more comfortable with these products. As the products are used with greater frequency, more practitioners become familiar with them and have a greater degree of confidence in using the products in their own deals.

There is a widely held view in the insurance community that paying claims is necessary for the continued growth in the use and acceptance of representations and warranties insurance.

3. Competition among representations and warranties insurance providers is intense. A number of new players have entered into this market seeking diversification in their books of business and to expand product offerings. The result has been an increased level of competition in this area among insurers. Competition favors the end user as pricing for the policies has declined significantly: from 8-10% of the insured amount 15 years ago to 2-4% of the insured amount today. Policy terms have become much more favorable from the insureds' perspective as market dynamics have forced insurance companies to adapt their terms to the needs and demands of the insureds or else suffer lost business opportunities.

4. The underwriting process for representations and warranties insurance policies has become streamlined and efficient. The insurance companies have developed underwriting processes that match the pace and intensity of the M&A deal environment. Underwriting can be completed within several business days, is not intrusive and will not disrupt the tone or pace of the underlying M&A transaction. The policy underwriting teams are responsive and focus on auditing the diligence work that has been done by the buyer as opposed to conducting their own due diligence review. The purchase agreement and disclosure schedules are reviewed by the insurance company and its counsel to identify unusual risks (or risk allocations) in the transaction. The long-term players in this space have used their years of underwriting experience to develop a practical and effective process that works for all of the deal participants.

5. Claims are regularly made and paid under the policies. According to an industry source, insurers report receiving claims on 20-30% of policies written. It is widely understood that claims routinely arise under these insurance policies and the insurance companies pay legitimate claims. There is a widely held view in the insurance community that paying claims is necessary for the continued growth in the use and acceptance of representations and warranties insurance. There is recognition that the claims process is part of the customer experience and is important to overall satisfaction with the product and its utility in the M&A deal environment.

Representations and warranties insurance is dramatically changing middle-market M&A practice and deal making. Embrace the change and realize that as long as it continues to be a seller's market, the growth of this product will continue to accelerate. ■

Despite Legal and Regulatory Marijuana Liberalization, Investors Face a Complex Landscape

The state-by-state spread of marijuana legalization has been met with little federal intervention, prompting increasing numbers of sophisticated investors to take a closer look at opportunities in the developing industry. However, the legal landscape is complicated, contradictory and continuously evolving, meaning investments require a heightened level of due diligence.

State of the Market

The trend toward liberalization is uneven, but all signs indicate that the legalization of both medical and recreational marijuana will continue to gain ground. Twenty-three states have legalized the growth and sale of marijuana for medical purposes, while Colorado, Washington, Alaska and Oregon have all legalized it for recreational purposes since 2012. More states may join that list depending on the results of various ballot and legislative actions being planned for 2015 and 2016.

A robust market has developed as a result of the legislative reforms. One industry research group calculates the state-legal marijuana market at $2.7 billion for 2014 — an increase of more than $1 billion from 2013 — while *Forbes* estimates the total U.S. marijuana market, including the black market, to be $50 billion.

> *A patchwork of varying models at the state level makes a one-size-fits-all approach to investment decisions impossible.*

Investment regulations and legislation have also adapted accordingly. In January, the SEC allowed the registration statement of a company with a business line dedicated to the growth and sale of marijuana to go effective, and several registration statements for other companies are currently on file with the regulator. Although the Department of Justice is still attempting to clarify its role as states liberalize their position on what remains – along with heroin, LSD and ecstasy — a Schedule 1 drug under the Controlled Substances Act, Congress has taken several steps to protect state-legal marijuana operations from federal impediments.

Despite the increased openness of the market, the investment opportunity is not to be taken lightly, as many serious issues remain unresolved. In addition to marijuana still being illegal under federal law, a patchwork of varying models at the state level makes a one-size-fits-all approach to investment decisions impossible. For medical marijuana, differences across the state models include the amount of marijuana that patients may possess and the number of plants they may grow, whether dispensaries are allowed, the types of medical conditions legally treatable with marijuana, and whether other states' medical cards are recognized. States also vary on the form of medical marijuana they allow. Many states — such as Alabama, Tennessee and Utah — restrict THC concentrations, while New York's recent reform prohibits smoking marijuana. The legal landscape is constantly evolving at both the state and federal levels.

In addition, the market segment has been the subject of investor warnings from both the SEC and FINRA, which have raised concerns about the accuracy of publicly available information of marijuana companies and pump-and-dump schemes, and the SEC's warning was accompanied by trading suspensions of a number of marijuana companies. To date, we are unaware of any marijuana companies that have been listed on a major exchange.

In spite of these challenges, opportunity exists for investors who are willing to accept the inherent risks.

Key Investment Considerations

While any investment in a marijuana enterprise requires sophisticated legal advice and extensive due diligence, below are certain high-level considerations relevant to investors:

- Stay abreast of changing priorities and developments in the regulatory landscape.
- Understand the impact of regulation on the specific investment opportunity.
- Review investment guidelines.
- Identify banking and cash security risks.
- Ensure appropriate insurance coverage.
- Perform a heightened level of due diligence.
- Realistically assess exit opportunities.

The array of legal issues in the marijuana industry is unique in both breadth and depth. However, as serious investment firms enter the sector, those that successfully navigate the numerous hurdles stand to gain an early foothold in this emerging multibillion-dollar industry. ■

The Law of Unintended Consequences: CFTC SEFs and Market Fragmentation

The issue of market fragmentation was at the forefront as the International Swaps and Derivatives Association (ISDA) recently held its Annual General Meeting (AGM) in April.

The trade group previously reported that an exclusive European pool in euro interest rate swaps (IRS) had developed, with an average of 87.7% of total euro IRS by volume being transacted between European dealers during the fourth quarter of 2014. By comparison, that same level averaged 73.4% during the third quarter of 2013. Meanwhile, swaps between European dealers and U.S. counterparties decreased to an average of 10.8% of total euro IRS by volume during the fourth quarter of 2014, compared with 25.8% during the third quarter of 2013. Notably, this change in behavior coincided with the CFTC's October 2013 implementation of swap execution facility (SEF) rules. In addition, although regional pools exist with respect to U.S. dollar IRS, ISDA notes that "evidence of fragmentation is more subtle than in the market for euro IRS."

In essence, the data suggests global liquidity pools have split since the SEF model was implemented, as European dealers have overwhelmingly chosen to do business with other European dealers. As a result, a significant market has developed beyond the reach of SEFs.

ISDA highlighted this example, along with several others, in an attempt to demonstrate how the various regulatory regimes that exist in different geographic jurisdictions are affecting market activity.

This lack of uniformity and its unintended consequences was also the subject of an ISDA white paper that laid out a set of guidelines for the centralized execution of derivatives. As these regulatory frameworks are developed, the guidelines call for them to be based on "a set of common principles" to ensure consistency between different jurisdictions and to create a common liquidity pool. ISDA believes that "continued cross-market growth will depend on the harmonization of rules in various regions."

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While the CFTC's SEF rules were implemented in 2013, the European Securities and Markets Authority (ESMA) is currently developing the details of similar regulations for Europe as part of MiFID II. ISDA has noted that ESMA's approach is better aligned with ISDA's own suggestions and will allow derivatives to trade on different trading venues with various execution mechanisms, while in contrast the CFTC's rules provide little regulatory flexibility.

CFTC chairman Timothy Massad was among the speakers at the April AGM, where he said derivatives markets "have become integral to the growth of the global economy by enabling businesses of all types to manage risk." However, the "package of modest regulatory amendments" he unveiled at the conference were far from the SEF overhaul ISDA desired and may do little to stem the tide of market fragmentation. ■