

**REGULATION U AND TOTAL RETURN SWAPS  
IN LIGHT OF THE SEC'S RECENT SETTLEMENT ORDER  
IN THE MATTER OF CANADIAN IMPERIAL HOLDINGS INC.  
AND CIBC WORLD MARKETS CORP.**

The Securities and Exchange Commission announced on July 20, 2005 the settlement of an administrative proceeding (the "Settlement Order") against Canadian Imperial Holdings Inc. ("CIHI") and CIBC World Markets Corp. ("World Markets"),<sup>1</sup> pursuant to which CIHI and World Markets were charged with violations of various securities laws. According to the Settlement Order: (a) CIHI financed hedge fund customers while knowing that the hedge funds would use the leverage to late trade and deceptively market time mutual funds; (b) CIHI provided, and World Markets arranged, improper financing for market timing by hedge fund customers in violation of margin requirements; and (c) a team of World Markets registered representatives enabled numerous customers to late trade and deceptively market time mutual funds.<sup>2</sup>

This memorandum focuses on the Settlement Order as it pertains to total return swaps ("TRSs") and violations of Regulation U of the Federal Reserve Board Regulations.<sup>3</sup> Significantly, the Regulation U violations the SEC claimed had involved a relatively straightforward credit arrangement that exceeded the 50% Regulation U limit; the use of TRSs was incidental to and not a necessary part of the violations themselves. Accordingly, we believe the Settlement Order need not be read to suggest more broadly that TRSs are themselves problematic under Regulation U. Nonetheless, the possibility that the SEC may look further into credit structures involving TRSs where the underlying purpose is to bypass credit limits cannot be dismissed.

## **I. Summary of Relevant Facts**

According to the Settlement Order, as part of its business, CIHI supplied leverage to its hedge fund customers, many of which participated in late trading and market timing of mutual funds.<sup>4</sup> The transactions worked as follows: (i) the client hedge fund and CIHI each contributed money and/or securities to an account (the "Managed Account") established at a broker-dealer or trust company, with the hedge fund's contribution typically equaling only 20% of the total and CIHI's

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<sup>1</sup> In the Matter of Canadian Imperial Holdings Inc. and CIBC World Markets Corp., Securities Act Release No. 8592, Exchange Act Release No. 52063, Investment Advisers Act Release No. 2407, Investment Company Act Release No. 26994, 2005 SEC LEXIS 1773 (July 20, 2005).

<sup>2</sup> Settlement Order, at ¶ 2.

<sup>3</sup> Regulation U, *Credit Extended by Banks for the Purpose of Purchasing or Carrying Margin Stocks*, 12 C.F.R. §§ 221.1, 221.7.

<sup>4</sup> Settlement Order, at ¶ 11.

contribution equaling the remaining 80%; (ii) the Managed Account was held in CIHI's name and CIHI retained the power to liquidate the shares held in the account at any time; (iii) the hedge fund client selected the investment manager to manage the account on a discretionary basis; (iv) the investment manager invested the Managed Account assets in the mutual funds purchased pursuant to the late-trading and market-timing schemes; and (v) the profits and losses in the account inured to the hedge fund's benefit exclusively by means of a TRS under which CIHI swapped the performance on the Managed Account to the hedge fund client for a LIBOR-based interest rate on CIHI's contributed capital. Effectively, then, CIHI extended 4:1 leverage to the hedge fund in the Managed Account, which was held only nominally in CIHI's name and of which, via the TRS, the hedge fund client was effectively the beneficial owner. CIHI preserved for itself the power to liquidate the Managed Account, which presumably it would exercise for its own protection if drawdowns in the Managed Account's assets equaled or exceeded the 20% stake the hedge fund client had contributed.

## II. Regulation U

Regulation U, *Credit Extended by Banks for the Purpose of Purchasing or Carrying Margin Stocks*, limits the amount of credit a lender (other than a broker-dealer, which is subject to comparable limits under Regulation T) can extend to its customers for the purpose of buying or carrying margin stock when such credit is secured directly or indirectly by the margin stock.<sup>5</sup> Here, the SEC charged that CIHI extended credit to hedge fund clients in excess of 50% of the fair market value of the securities in the account—the Regulation U limit—through the arrangement it had structured.<sup>6</sup>

## III. The Settlement Order as it Relates to Regulation U and TRSs

The Settlement Order is ambiguously drafted: it states that the excess credit was provided “purportedly” through the use of the TRSs and then states that the TRSs were themselves extensions of the credit that violated Regulation U.<sup>7</sup> Nonetheless, the SEC later clarified what it meant: “CIHI extended credit to hedge fund customers in excess of the margin stock's value through *what it characterized as TRSs . . .*” [emphasis added]. More plainly stated, the SEC concluded that the TRSs were derivatives in form, but were financings in substance. The violation they claimed was in granting the 4:1 leverage on an account that, in substance, was for the hedge fund client's own account and risk. Through the TRSs, the client had all the upside (and downside) and its capital was the first to be lost on the account.

We believe that this case need not be read to suggest more broadly that TRSs are by themselves at risk of being deemed to involve an improper extension of credit in the absence of underlying facts such as these. What the SEC is suggesting, though, is that it will examine structures in

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<sup>5</sup> 12 C.F.R. §§ 221.1, 221.7.

<sup>6</sup> Settlement Order, at ¶ 49.

<sup>7</sup> *Id.* at ¶ 4.

which TRSs are used to see whether there is at bottom a capital contribution arrangement — such as the 4:1 capital contribution CIHI made — that involves excessive leverage where the assets in the account are being used to purchase or trade in margin securities. That, it should be recognized, may lead the SEC to evaluate other structures where TRSs are used and where the underlying facts imply that the principal purpose is to bypass the credit limits under Regulation T or Regulation U.

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If you have any questions concerning the foregoing or would like further information, please call Roger D. Blanc at (212) 728-8206, Emily M. Zeigler at (212) 728-8284 or the attorney with whom you regularly work.

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