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Regulatory and Cross-Border Issues for Proprietary Trading Firms

Janet M. Angstadt
Head, Chicago Financial Services Practice
Katten Muchin Rosenman LLP

Christian B. Hennion
Partner, Financial Services Practice
Katten Muchin Rosenman LLP

Carolyn H. Jackson
Partner, Financial Services Practice
Katten Muchin Rosenman UK LLP

Nathaniel Lalone
Partner, Financial Services Practice
Katten Muchin Rosenman UK LLP

Neil Robson
Partner, Financial Services Practice
Katten Muchin Rosenman UK LLP

Lance A. Zinman
Global Co-Chair, Financial Services Practice
Katten Muchin Rosenman LLP

Agenda

United Kingdom/European Union

- Update on MiFID II
- Brexit Implications
- Senior Managers and Certification Regimes
- Cybersecurity Initiatives

United States

- Regulation AT
- SEC/FINRA Proposals for Algorithmic and Proprietary Traders
- Tax Concerns and Structuring Implications
- Advisory and Pool Registration Pitfalls

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Update on MiFID ii & MiFIR

Nathaniel Lalone
Partner, Financial Services Practice
Katten Muchin Rosenman UK LLP

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In General

- MiFID II and MiFIR touch nearly all aspects of the European financial markets with an emphasis on transparency, market structure, trading, and transaction reporting.
- Both have been drafted so as to complement other European financial legislation, including:
  - EMIR;
  - MAR; and
  - REMIT.

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MiFID II

- Requires national implementation measures, hence some margin for manoeuvre.
- Topics covered include:
  - scope of authorisation and exemptions for investment firms;
  - conduct of business, organisational and business standards;
  - regulation of trading venues (including the new OTF);
  - position limits and position management regime;
  - third country branching for EU retail clients; and
  - data reporting.

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MiFIR

- Uniformly application for maximum harmonisation.
- Topics covered include:
  - pre- and post-trade transparency;
  - transaction reporting;
  - mandatory trading of certain OTC derivatives;
  - indirect clearing;
  - open (“non-discriminatory”) access;
  - third-country passport regime;
  - supervisory interventions.

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Timeline – Where Are We?

- May 2014
  - adoption of Level 1 texts
- December 2014
  - publication of Consultation Paper for draft regulatory technical standards ("**RTS**") and implementing technical standards ("**ITS**")
  - publication of final draft technical advice to European Commission ("**EC**")

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Timeline – Where Are We?

- September 2015
  - Publication of some, but not all, final RTS
  - EC had 3 months to decide whether to adopt the RTS, subject to right of European Parliament and European Council to object
- November 2015
  - ESMA reopened a consultation period for indirect clearing arrangements under EMIR (OTC) and MiFIR (ETD)
  - Consultation period closed in December 2015

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Timeline – Where Are We?

- Today
  - No formal decision to prolong the implementation process
  - EC has not adopted any delegated acts pursuant to ESMA's final technical advice
- Delayed implementation timeline
  - Normally, national implementing measures must be transposed into law by 3 July 2016 and MiFID II and MiFIR take effect on 3 January 2017
  - Discussions to date have focused on a 1-year delay, although a 2-year delay may be possible.

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Brexit implications and senior managers certification regime

Neil Robson
Partner, Financial Services Practice
Katten Muchin Rosenman UK LLP

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MiFID II – Implications of a Brexit I: The EU Referendum

- The Conservative Party's election manifesto promised to hold a referendum on whether or not the UK should stay or leave the EU if they won the election; they did, so the referendum will be taking place.
- David Cameron promised that it would take place by the end of 2017, though political commentators are suggesting that it could be as soon as June 2016 (given the UK's position will likely be debated at an EU Council meeting in February).
- The UK's last referendum on membership of the then-entitled "Common Market" was in 1975.

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MiFID II – Implications of a Brexit II: The EU Referendum

- David Cameron is currently trying to renegotiate the UK's "membership package" within the EU. He is negotiating four key objectives: economic governance, competitiveness, immigration and sovereignty.
- The 'out' campaign is already lobbying vigorously, but the stay 'in' campaign has a quieter voice currently, pending the outcome of Mr Cameron's negotiations. (Cabinet ministers are only permitted to campaign 'in' or 'out' upon the outcome becoming clear).
- British, Irish and Commonwealth citizens over age 18 and currently resident in the UK will be able to vote, as will UK nationals who have lived outside the UK for less than 15 years.
- The 'in' or 'out' vote will be passed by a majority – i.e., 50% of all votes actually cast on the day - plus one vote. This will decide whether the UK stays in or leaves the EU.

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MiFID II – Implications of a Brexit III: If the UK is 'Out'

- If the UK exits the EU, there will be a number of years (decades possibly) during which pre-existing UK legislation implementing EU directives and regulations has to be assessed and either amended, replaced or repealed.
- Once the UK is out, UK financial services firms will be non-EU firms (known in EU legal terminology as "third country firms"), putting UK firms in the same position as US firms as regards activities in the EU.
- MiFID II and MiFIR incorporate a process proposing to introduce a common regulatory framework at EU level, such that IF a third country's national rules outside the EU are deemed of equivalence to the EU's prudential and business conduct framework, the non-EU firm could register with ESMA and then provide its services in the EU (with a passport for cross-border activities).

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MiFID II – Implications of a Brexit IV: If the UK is 'Out'

- Without such an equivalence determination at a central level, only two options would remain for access to EU markets:
  - If the relevant EU Member State allows it, the non-EU firm could establish a branch in the EU country and get itself locally authorised (no passport); or
  - If the relevant EU Member State elects to use the MiFID carve out such that non-EU firms can access the specific EU country's markets (along the lines of the UK's overseas persons exclusion), that specific country may be open to cross-border services being provided. (The UK has been the only EU country to use such carve out so far).

(It should be noted that MiFIR states that once an equivalence determination has been made at a pan-EU level, any such national third country regimes would cease).

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FCA Senior Managers & Certification Regime I

- HM Treasury announced in October 2015 that the current proposals for rules requiring senior banking individuals to have more responsibility in designated areas within banks operating in the UK should be extended to all UK firms regulated by the Financial Conduct Authority ("FCA") and/ or the UK Prudential Regulation Authority ("PRA").
- The Senior Managers and Certification Regime ("SM&CR") comes into effect in March 2016 for all British and overseas banks operating in the UK. It requires that senior managers must have identified areas of responsibility and introduces a "duty of responsibility" for such individuals so that if there are failings, key individuals can be identified and penalised.

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FCA Senior Managers & Certification Regime II

- The SM&CR for banks was introduced by the UK government as a reaction to the financial crisis and the associated public frustration that few individuals were prosecuted for failings at the banks - despite the fact that key banks had to be bailed out using vast sums of public money.
- With the new SM&CR, the FCA or the PRA will be able to point to key individuals if management failings are identified in banks operating in the UK and, consequently, those individuals will need to ensure that their areas of responsibility are properly managed to avoid incurring liability.
- HM Treasury's announcement to extend the SM&CR more widely means that it will become a full replacement for the current approved persons regime – which the UK Parliamentary Commission has referred to as a "complex and confused mess" with a restricted scope and a lack of clarity. Instead, it is intended that the SM&CR will require the creation of "responsibilities maps" – causing senior individuals within all regulated firms to be more visible and thereby allow regulators to take direct action against them, if necessary.

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FCA Senior Managers & Certification Regime III

- The SM&CR will come into operation for banks, building societies, credit unions and PRA-regulated investment firms on 7 March 2016 and such firms shall have one year from this date to complete the certification of existing staff.
- It is intended that the SM&CR will apply to all other regulated UK firms from 2018.

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FCA Senior Managers & Certification Regime IV

- The Senior Managers Regime will directly replace the approved persons regime in relation to persons performing the senior roles in a firm.
- These roles (known as Senior Management Functions - SMFs) will be specified in rules made by the PRA and FCA. Firms need to provide for individuals already approved (e.g. as “CF1” directors, “CF2” non-executive directors, “CF3” chief executives, “CF4” partners) to be ‘grandfathered’ into relevant roles in the new SM&CR.
- Those regulated firms planning a new senior manager appointment, or a material change in role for currently approved individuals, will have to apply to the FCA or the PRA to get such persons approved. Individuals will not be permitted to take up a SMF role until the FCA or the PRA have given their written consent.

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FCA Senior Managers & Certification Regime V

- The parallel **Certification Regime** will apply to individuals who are not carrying out SMFs but whose roles are deemed capable of causing *significant harm to the firm or its customers*; such roles will almost certainly include all persons currently registered with the FCA and the PRA under the approved persons "CF30" controlled function – which includes all customer-facing individuals such as advisors, as well as portfolio managers.
- The certification regime will require regulated firms themselves to assess the fitness and propriety of persons performing such key roles, and to formally certify this at least annually. Persons in these significant harm functions will likely also be notified by firms to the FCA and the PRA, although it will not be necessary to obtain the relevant regulator's prior consent.

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FCA Senior Managers & Certification Regime VI

- HM Treasury has stated that it anticipates that most current approved persons below senior management level are expected to be certified. It is not yet clear whether there will be any certification requirements for a firm's general counsel, a firm's chief compliance officer ("CF10" in the approved persons rules) or the money laundering reporting officer ("CF11") or if such persons will be considered as senior managers requiring regulatory approval.
- The burden of proof will be on regulated firms to certify at least annually that applicable staff are "fit and proper" to be able to perform their role – which will likely include comprehensive due diligence in obtaining references for new candidates as well as ensuring that updated training is undertaken by relevant current employees etc. Any failings within a firm could lead to the relevant senior manager having personal liability and being penalised by the PRA or the FCA.

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Cybersecurity initiatives

Carolyn Jackson
Partner, Financial Services Practice
Katten Muchin Rosenman UK LLP

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Overview

- Introduction;
- What is cybersecurity?
- UK context;
- Systems and controls requirements;
- EU context and developments;
- US perspective;
- Industry initiatives;
- Other relevant materials.

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What is cybersecurity?

Why is cybersecurity relevant to proprietary trading firms?

Proprietary trading firms have sensitive, precious internal technology, data and assets to protect, including:

- Algorithms, source codes, platform information, trading models and internal technology;
- Firm trading data, strategies, opinions, book positions (past, present and planned) and research (internally produced and externally provided).

Protecting against internal and external cyber-threats

Cyber-threats can originate from external hackers, viruses and phishing attempts, and also, from within an organisation (such where internal staff deliberately access sensitive data or codes and share them with third parties).

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UK Context

Relevant UK laws governing cybersecurity

Cybersecurity is regulated by a variety of pieces of legislation in the UK (including in relation to telecommunications, privacy and official secrets). There is not one single piece of legislation that governs cybersecurity (however as will be explored, this may be impacted by the new EU Cybersecurity Directive). Various other initiatives (government, industry-led and otherwise) provide guidance and frameworks for firms in relation to cybersecurity.

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Systems and controls requirements

Regulated

Where firms are regulated by the FCA, handbook provisions such as SYSC set out systems and controls requirements.

SYSC 3.1 Systems and Controls

- *A firm must take reasonable care to establish and maintain such systems and controls as are appropriate to its business.*

Unregulated (but potentially captured by MiFID II)

Firms brought into the regulatory scope of MiFID II should take note of systems and controls requirements under MiFID II and MiFIR (such as those under Article 17 in relation to algorithmic trading, high-frequency trading and direct market access).

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UK Initiatives I

FCA Business Plan 2015/2016

Cyber-crime and cyber risk are on the FCA's radar. In March 2015, the FCA published its Business Plan for 2015/16. The FCA specifically mentioned the increasing risks of cyber-crime and noted the potential for cyber-crime to "significantly disrupt financial markets".

UK Cyber Security Strategy – Protecting and promoting the UK in a digital world

In November 2011, the UK Government released a *Cyber Security Strategy* paper, which set out its "vision for UK Cyber Security in 2015".

- On 8 May 2015, the Government released an updated Policy Paper, *2010 to 2015 Government Policy: Cyber Security,* on measures intended to boost cybersecurity in the UK. The Government included in the announcement that it has allocated £860 million until 2016 to establish a "*National Cyber Security Programme*"

CERT-UK (the National Computer Emergency Response Team)

- CERT-UK was formed in March 2014. CERT-UK is tasked to work with industry, government and academia to enhance cybersecurity in the UK. It is considered a "pillar" of the National Cyber Security Programme and is expected to collaborate with national CERTs around the globe.

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UK Initiatives II

Cyber Security Breaches Survey 2016

- On 11 November 2015, the Government announced it was surveying UK businesses (selected at random) on their approach to cybersecurity, with a view to publish anonymous findings in early 2016.
- The survey is designed to "provide up-to-date information on how businesses approach cybersecurity, help organisations learn more about cybersecurity issues faced by business" and "to inform Government policy on cybersecurity".

UK and US joint exercise to enhance responses to cyber-incidents

- On 12 November 2015, the UK and US Governments conducted a joint exercise with leading global financial firms to enhance understanding in relation to information sharing, incident response handling and public communications in the event of a cyber-incident.

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EU Context

Relevant EU laws governing cybersecurity

Cybersecurity in the EU is (similar to the UK) spread across a variety of areas such as telecommunications and data protection. However the European Commission (the "Commission") has recognised the need for uniformity across the EU in relation to cybersecurity measures. A key part of this initiative is the new EU Cybersecurity Directive.

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EU Initiatives

EU Cybersecurity Strategy

In February 2013, the Commission published a *Cybersecurity Strategy of the European Union – An Open, Safe and Secure Cyberspace* ("Cybersecurity Strategy").

- The Cybersecurity Strategy lists five "strategic priorities" for the EU including:
  - Achieving cyber resilience;
  - Drastically reducing cybercrime;
  - Developing cyberdefence policy and capabilities related to the Common Security and Defence Policy;
  - Develop the industrial and technological resources for cybersecurity; and
  - Establish a coherent international cyberspace policy for the EU and promote core EU values.

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EU Developments

EU Cybersecurity Directive

- On 8 December 2015, the Commission announced that the European Parliament and the Luxembourg Presidency of the EU Council of Ministers agreed the text of a new EU Cybersecurity Directive.
- The EU Cybersecurity Directive was first proposed by the Commission in February 2013. The Commission published a *Proposal for a Directive concerning measures to ensure a high common level of network and information security across the Union*, which included draft potential text of the EU Cybersecurity Directive.
- The 2013 proposed text (and subsequent iterations) gives clues as to what the final Directive might require, and contains draft provisions for Member States to:
  - Adopt a national strategy to "achieve and maintain a high level of network and information security";
  - Designate a national competent authority on the security of network and information systems (among other requirements).

The new EU Cybersecurity Directive was expected to be published in December 2015, however is yet to be released.

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US Perspective

On 16 December 2015, the Commodity Futures Trading Commission "unanimously approved" proposals to amend and enhance existing rules on cybersecurity for derivatives, clearing organisations, trading platforms and swap data repositories.

- The proposals were published in separate Federal Register notices and contain specific enhancements to cybersecurity testing requirements.

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Industry-related initiatives I

Hedge Fund Standards Board ("HFSB")

The HFSB is a standard setting body and custodian of the Hedge Fund Standards.

Cyber Attack Simulation

On 21 January 2016, the HFSB published findings on its first cyber-attack simulation.

- The simulation was designed to test the responses of fund managers in respect of three scenarios (data theft and leakage of internal sensitive data, financial infrastructure attacks and incidents involving "crypto ransomware").
- One of the key findings of the HFSB was that firms must prepare in advance for cyber-attacks and implement clear incident response plans.
- A further key finding was that managers must be able to recognise when certain cyber-attack incidents require "external legal and IT expertise" and seek such assistance accordingly.

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Industry-related initiatives II

Cyber Security Memo – HFSB Toolbox

- One of the initiatives of the HFSB is to maintain a "Toolbox" of guidance, to support the Hedge Fund Standards.
- In September 2015, the HFSB added a *Cyber Security Memo* to the Toolbox, which contains practical guidance to assist firms to build risk management tools, identify "key digital assets" and to develop response plans in the event of a cyber-attack.

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Industry-related initiatives III

Alternative Investment Management Association ("AIMA") - Guide to Sound Practices for Cyber Security

- On 6 October 2015, AIMA published a *Guide to Sound Practices for Cyber Security* (Guide). The Guide (whilst not directly relevant to proprietary trading firms) may be good guidance for all firms.

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Other relevant materials

- CERT-UK publishes best practice guides on cybersecurity topics
- International Organisation for Standardisation issues standards on governance, systems and controls (in relation to information security management systems, protection of electronic information and privacy and security for cloud computing).

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SEC/FINRA Proposals for Algorithmic and Proprietary Traders

Janet Angstadt
Head, Chicago Financial Services Practice
Katten Muchin Rosenman LLP

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SEC Proposal to Amend SEC Rule 15b9-1

- Proposed March 2015 – Action expected in 2016
- If approved, would require most US broker-dealers to become FINRA members
- Current SEC Rule 15b9-1 allows a proprietary trading broker-dealer to avoid FINRA membership if the broker-dealer
  - is a member of at least one securities exchange
  - maintains no customer accounts
  - trades only on exchanges or with other broker-dealers
- Proposal is designed to ensure that all off-exchange activity is regulated by FINRA
- If approved, only US broker-dealers that limit activity to securities exchanges (where a member) could avoid FINRA membership

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SEC Proposal to Amend SEC Rule 15b9-1
(cont.)

- Consequences of FINRA membership for proprietary trading firms
  - Proprietary trading firms that are exchange members are already examined/surveilled by FINRA (i.e., FINRA as agent of exchange SROs)
  - Proposed approach would give FINRA complete enforcement discretion
  - FINRA membership will add costs to prop trading firms (e.g., trading activity fees, audit trail requirements, approval for material changes in operation, etc.)
  - Additional FINRA registration categories for personnel

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Trader/Dealer Distinction

- Dealer – “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise”
- A dealer must register with the SEC
- The definition of dealer does not include a “trader”
- SEC officials: The SEC will clarify the status of unregistered active proprietary traders to subject them to SEC rules as dealers

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FINRA Proposal to Register Developers of Trading Algorithms

- March 2015 – proposal made to FINRA membership but not yet filed with SEC for approval.
- If approved, would require the registration of associated persons of FINRA-member firms who are:
  - primarily responsible for the design, development or significant modification of an algorithmic trading strategy”; or
  - supervisors of such activities.

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SEC Disruptive Trading Rule Proposal?

- Chair White: "I've directed the staff to develop a volatility moderator – an anti-disruptive trading rule – that would focus on the demand side of a liquidity imbalance."
- Concern that the use of aggressive, destabilising trading strategies in vulnerable market conditions exacerbates price volatility
- Proposed rule would be based on defined market triggers

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CFTC Proposed Regulation AT

Lance A. Zinman
Global Co-Chair, Financial Services Practice
Katten Muchin Rosenman LLP

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Introduction – What is Regulation AT?

- Proposes to federalise the futures industry's best practices for algorithmic trading and existing self-regulatory organisation requirements
- Follows the CFTC's September 2013 Concept Release on Risk Controls and System Safeguards for Automated Trading
- Proposed rules standardise risk controls, transparency measures and other safeguards
- Principles-based regulatory scheme
- Three principal categories of participants are regulated by the proposal: AT Persons, FCMs, and DCMs (i.e. three levels of oversight)

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Overview: AT Persons

- Who is an AT Person?
  - Specified CFTC registrants engaged in algorithmic trading
  - Persons required by Regulation AT to register as floor traders (proposed § 1.3(xxxx))
- What constitutes “Algorithmic Trading”?
  - Broad scope of futures trading activity (proposed § 1.3(ssss))
  - Includes use of algorithmic and automated trading systems

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Overview: Floor Traders

- Who is a "Floor Trader" under Regulation AT?
  - Any non-CFTC registrant using an algorithmic trading system ("ATS") to route electronic orders directly to a DCM, rather than first through a clearing member FCM
    - "without the order first being routed through a separate person who is a member" of a DCO (§ 1.3(yyyy))
  - Once registration is required for direct access, the firm is an AT Person for all algorithmic trading – direct and non-direct
  - No minimum activity threshold that might exclude potential AT Persons from registering with the CFTC as floor traders
  - Existing floor traders are not AT Persons (proposed § 1.3(xxxx))

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Overview: AT Persons

- Must comply with all Regulation AT requirements
- Must implement pre-trade risk controls and other measures "reasonably designed" to avoid an "Algorithmic Trading Event"
- What is an "Algorithmic Trading Event"?
  - Compliance breach **of any magnitude** (an "algorithmic trading compliance issue")
  - Operational breakdown that is disruptive at any level (an "algorithmic trading disruption")
    - "disrupts or materially degrades" (§ 1.3(uuuu))

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Overview: AT Persons (continued)

- AT Persons must put in place:
  - Maximum order message and execution frequencies
  - Order price parameters and maximum order size limits
  - Written policies/procedures that address:
    - Development and testing of an ATS
    - The designation and training of staff responsible for algorithmic trading
    - Escalation and communications procedures in the event of an Algorithmic Trading Event
  - Annual report filed with each relevant DCM which must include:
    - Description of pre-trade risk controls
    - CCO or CEO Certification

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Overview: AT Persons (continued)

- Significant requirements for AT Persons include:
  - Maintaining copies of the source code used in a live environment (including all changes)
    - "[m]aintaining a source code repository to manage source code access, persistence, copies of all code used in the production environment, and changes to such code" (§ 1.81(a)(1)(vi))
  - Complying with the CFTC's five-year record-retention requirements
  - Making source code available for inspection by the CFTC/DOJ without subpoena or legal process (proposed § 1.81(a)(1)(vi))

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Overview: FCMs

- Proposed rules would affect any FCM that:
  - Is a clearing member of a DCM
  - Carries accounts for customers who use an ATS
- This is in addition to FCMs who are AT Persons themselves

Overview: FCMs (continued)

- Policies/procedures to prevent Algorithmic Trading Events:
  - Ensure natural person employees are promptly informed when pre-trade risk controls are breached
  - For direct access clients, clearing member FCMs must implement the pre-trade risk controls and order cancellation systems provided by the DCMs
  - For other clients, DCMs should establish and maintain their own pre-trade risk controls and order cancellation systems (proposed § 1.82)
  - Must file an annual report with each relevant DCM that includes:
    - Description of how the FCM complies with the maintenance of pre-trade risk controls
    - Description of CCO or CEO Certification

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Overview: DCMs and RFAs

- Proposed rules would affect
  - DCMs
  - NFA
- SEFs are not affected

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Overview: DCMs and RFAs (continued)

- DCM policies/procedures to prevent Algorithmic Trading Events:
  - Must adopt risk controls for orders submitted through Algorithmic Trading to include pre-trade risk controls and order cancellation systems (proposed § 40.20)
  - Must maintain parallel controls for orders not originating from Algorithmic Trading (i.e., manually submitted)
  - Must require the submission and review of compliance reports from AT Persons and their clearing member FCMs
  - Must implement rules to reasonably prevent self-trading by market participants. Must apply, or provide and require the use of, self-trade prevention tools to prevent self-trading
  - DCMs must also disclose attributes of their matching systems that materially affect market participant orders, as well as information regarding market maker and trading incentive programs

Overview: DCMs and RFAs (continued)

- Regulation AT also requires NFA to implement and maintain:

  "a program for the prevention of fraudulent and manipulative acts and practices, the protection of the public interest, and *perfecting the mechanism* of trading on designated contract markets…"

- The CFTC expects NFA to adopt rules "as deemed appropriate" that require its members to establish:
  - Pre-trade risk controls and other measures for ATS
  - Standards for developing, testing and monitoring ATSs and compliance
  - Designation of algorithmic trading staff and the provision of training for such persons
  - Operational risk management standards for FCMs whose orders originate with ATSs

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Comparison: Status Quo – AT Persons

- FIA PTG Best Practice Principles
  - Market Access Risk Management Recommendations, April 2010
  - Recommendations for Risk Controls at Trading Firms, November 2010
  - Software Development and Change Management Recommendations, March 2012
  - Order Handling Risk Management Recommendations for Executing Brokers, March 2012
  - Drop Copy Recommendations, September 2013
  - Guide to the Development and Operation of Automated Trading Systems, March 2015

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Comparison: Status Quo – AT Persons (continued)

- Pervasive futures exchange requirements (Traders):
  - Entities connecting to Globex through CME iLink Gateway
    - Must create and maintain an audit trail for all orders for five years
    - Must ensure all orders include an appropriate identifier – Tag 50 (CME Rule 536.B)
  - Requires certification (CME Rule 536.B)

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Comparison: Status Quo – AT Persons (continued)

- Futures exchanges have fined firms for trading system breakdowns that disrupt or could have disrupted the marketplace
  - 2014: A Proprietary Trading Firm
    - CME Group - $35,000
    - Third-party-purchased system caused 3,540 one-lot round-turn transactions in Canadian dollar futures contracts within two minutes on 10 November 2011
  - 2014: A Proprietary Trading Firm
    - CME Group - $75,000
    - System breakdown caused 27,000 resend messages within two seconds on 8 May 2013

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Status Quo – FCMs

- Clearing members must "suspend or terminate" a non-member's Globex access if the member:
  - Poses a threat to the exchange
  - Fails to cooperate in an investigation (CME Rule 574)
- Clearing members may be found to have committed an "act detrimental to the interest or welfare of the Exchange" if it has "actual or constructive notice" of a rule violation by a non-member that has a direct connection and it fails to take "appropriate action" (CME Rule 574)(Equivalent ICE Futures US Rule 27.04(d))

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Status Quo – FCMs

- EFS and Tag 50s
  - If an entity is required to be registered with the Exchange, “it is the duty of the clearing member to ensure that registration is current and accurate at all times” (CME Rule 576)
  - Each individual must use a unique identifier when entering an order to Globex (CEM Rules 536B.1, 576) (May be team IDs)
  - Clearing members guaranteeing connections to Globex “are responsible for maintaining or causing to maintain electronic audit trail” for five years unless another clearing member or corporate equity member
  - Clearing members “must have the ability to produce this data in a standard format” to CME Group (CME Rule 536.B.2)

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Status Quo – FCMs (continued)

- See other futures exchange equivalent requirements:
  - ICE Futures Rule 27.12A
  - CFE Rule 403
- FCMs may have audit trail retention requirements (maintain or causing to be maintain required records) for direct access clients (CME Rule 536.B.)
  - Even where maintaining requirement can be delegated (e.g., equity members), CME will now obligate sponsoring FCMs to produce required records to CFTC when requested (MRAN RA1520-5 (14 December 2015))
- CFTC Rules 1.73 (risk management), 166.3 (supervision)
- NFA Interpretive Notice 9046 to Rule 2.9 (Supervision of the Use of Automated Order-Routing Systems)

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Chief Compliance Officers

- An AT Person's CEO or CCO must certify that the annual report information is accurate and complete
- For FCMs, another annual report to file
- What is the potential liability of compliance officers?

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Potential Consequences of Regulation AT - Difficulties

- AT Persons will be exposed to enforcement risks for failing to comply with their own written policies and procedures
- AT Persons might hesitate before adopting internal requirements beyond the minimum CFTC requirements
- Cost of implementing will have a deleterious effect on at least some FCMs

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Potential Consequences of Regulation AT - Difficulties

- Burdensome for CFTC registrants to have their source code available for inspection by the CFTC or DOJ
- Third parties may inadvertently obtain access to information obtained by the government
- Unclear whether NFA could adopt such a program without amending its articles of incorporation

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Potential Consequences of Regulation AT - Benefits

- Newly registered Floor Traders may avoid Swap Dealer registration
- Higher confidence in algorithmic trading by FCMs

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Securities Regulation Comparison

- SEC Rule 15c3-5 requires broker-dealers to have pre- and post-trade risk controls for direct access to exchanges and dark pools (i.e., where a broker-dealer uses its own MPID):
  - Risk controls must cover prescribed financial and regulatory risks
  - Annual compliance certification
- Regulators take an expansive view of the rule
- Routinely added by regulators to address garden-variety trading violations

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Securities Regulation Comparison (continued)

- Financial Risk Controls
  - Must be reasonably designed to limit the financial exposure of the broker or dealer that could arise as a result of market access
  - Prevent orders exceeding pre-set credit or capital thresholds in the aggregate by rejecting orders if they would exceed the threshold
  - Prevent the entering of erroneous orders by rejecting orders that exceed appropriate price or size parameters or that would indicate duplicate orders

Securities Regulation Comparison (continued)

- Regulatory Risk Controls
  - Reasonably designed to ensure compliance with all regulatory requirements
  - Prevent order entry unless compliance with all regulatory requirements that must be satisfied on a pre-order basis (e.g., order origin codes, Reg SHO order marketing, etc.)
  - Prevent order entry for securities if a firm is restricted from trading those securities
  - Restricted access to trading systems and technology that provide market access to persons pre-approved and authorised
  - Ensure that appropriate personnel receive post-time execution reports

Conclusion

- Economic self-interest to implement risk controls
  - Prevent the loss of capital
  - Much of the proposal is reiteration of market practice
- Implementation costs will have a deleterious impact on at least some FCMs
- Source code issue must be resolved
- Comments due on or before 16 March 2016

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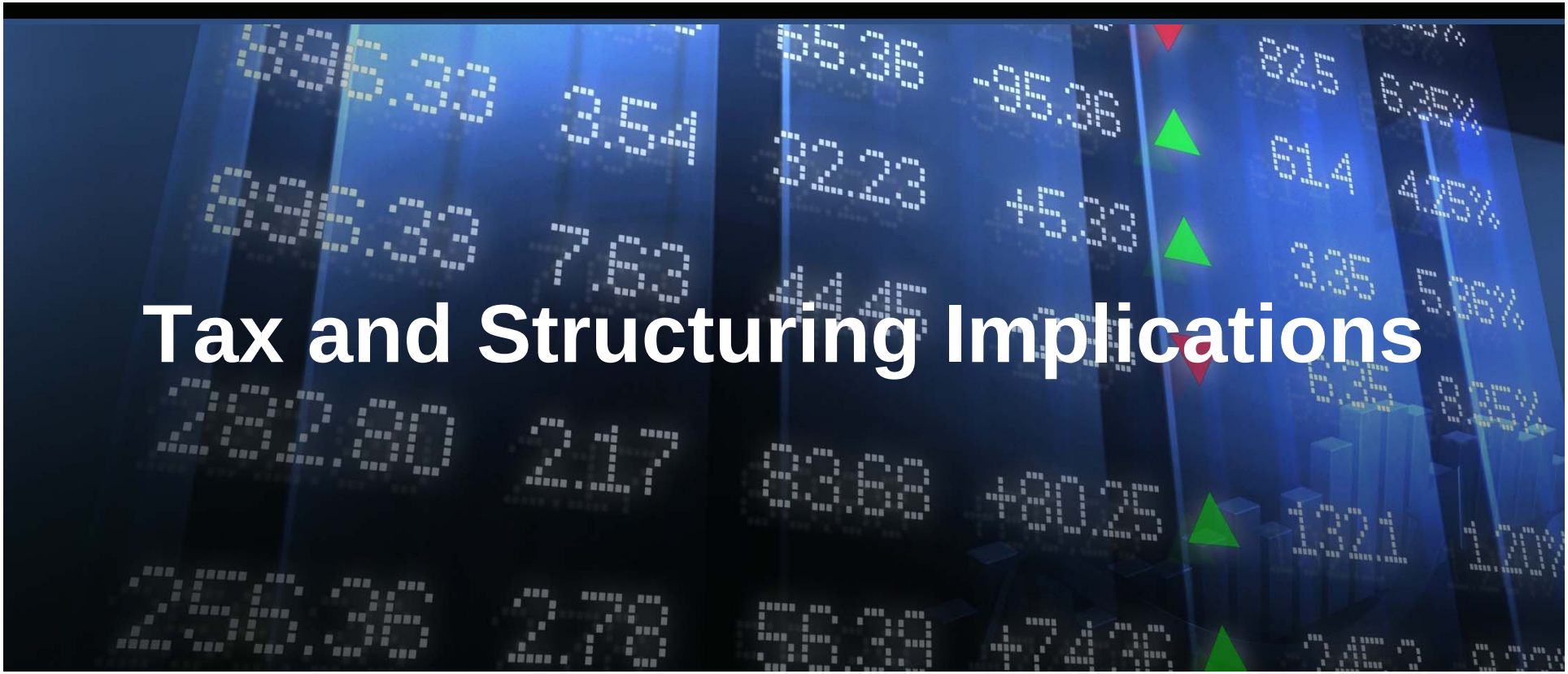

Tax and Structuring Implications

Lance A. Zinman
Global Co-Chair, Financial Services Practice
Katten Muchin Rosenman LLP

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Katten Muchin Rosenman UK LLP

US Tax Considerations for Foreign Firms

- Effectively Connected Income (ECI) is subject to corporate tax and, in general, 30% US branch profits tax, unless reduced or eliminated by treaty
  - Branch profits tax is 5% for UK taxpayer firms eligible for UK treaty benefits (on top of other relevant US corporate taxes)
  - In a few cases, the relevant treaty may allow ECI to not be taxed if the foreign company does not have a permanent establishment in the US that gives rise to the ECI
- Must be engaged in a trade or business within US to generate ECI
  - Activities within US must be regular and continuous
  - Activities of “agents” in US may be attributed to foreign principal

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US Tax Considerations for Foreign Firms (cont.)

- Limited guidance as to quantum of activity needed to be engaged in a trade or business within US
- "Dealer" or market-making activities may generate ECI
- A partner is deemed to be engaged in the business of the partnership. Accordingly, a partnership's ECI will be allocated to its partners.

- If there is no ECI, there will be no US corporate income tax, but certain US sourced income (e.g., dividends and certain dividend equivalents) earned will be subject to withholding at 30%, unless reduced by a treaty.
  - Generally, the dividend withholding rate is reduced pursuant to treaty with the UK from to 30% to 15%, 5% or 0% depending on if the shareholder owns the voting shares of the dividend paying company.

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US Tax Considerations for Foreign Firms (cont.)

- Section 864 of the Code provides that trading in securities and commodities for one's own account will not cause a foreign entity to be engaged in a US trade or business (the income is not ECI). Proposed regulations extend this safe harbor to derivatives in securities and commodities.
- Safe harbor may not apply to:
  - Dealers and market makers
  - Loan originators
  - US real property interests (which includes shares of US real property holding corporations, subject to various exceptions)

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US Tax Considerations for Foreign Firms (cont.)

- If there is substantial risk of ECI, the foreign firm would typically use a US C Corporation as a blocker
  - US expenses would reduce US tax
  - There would be US withholding on dividends
  - Dividends should be exempt from UK tax when received by the UK parent
  - May need to structure around “reverse VAT” in the UK if US entity provides services to the UK parent

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Considerations for US Firms in the UK

- US proprietary firms are typically structured as limited liability companies or limited partnerships for tax and other reasons
  - We advise that proprietary firms establish a holding company and various subsidiaries (including intellectual property and infrastructure holdcos)
- To obtain MiFID II or German HFT authorisation, US firms need to have a presence in the EU, but will prefer to keep income in the US for tax reasons
  - An FCA-regulated limited liability partnership in the UK allows the US firm (i) to passport within the EU for regulatory purposes and (ii) to calculate tax by reference to profits attributable to the UK business (i.e., allowing the US firm to allocate profits to the UK based on transfer pricing principles)
  - With a properly constructed Trading Services Agreement, a US firm's UK entity can provide services into the US and avoid the 20% UK value-added tax.

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SEC and CFTC Advisory and Pool Registration Pitfalls

Christian B. Hennion
Partner, Financial Services Practice
Katten Muchin Rosenman LLP

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“Asset Manager” Regulation

- Proprietary trading firms, by virtue of managing money for their own accounts, generally do not find themselves categorised as regulated asset managers
  - However, the presence of passive/outside investors in the structure may raise the issue
  - In addition, service providers and trading counterparties may be asking these questions more frequently today than they have historically
- Regulatory guidance in this area is limited
  - Positive, in that there has been little enforcement activity
  - Negative, in that the limits/applicability of regulation have not been clearly defined
- Encouraging that regulators seeking to regulate the industry recently have not been citing CPO or IA regulation as the “go-to” category for proprietary trading firms – not a good fit for proprietary trading operations

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Commodity Pool / CPO Regulation

- Most likely CFTC registration category that might come up for prop firms
- NFA Bylaw 1101 – self-policing provision applicable to CFTC registrants (such as FCMs, IBs, etc.)
  - "*No Member [of the National Futures Association ("NFA")] may carry an account, accept an order or handle a transaction in commodity futures contracts for or on behalf of any non-Member of NFA, or suspended Member, that is required to be registered with the Commission as an FCM, IB, CPO, CTA or LTM, and that is acting in respect to the account, order or transaction for a customer, a commodity pool or participant therein, a client of a commodity trading advisor, or any other person.*"
- Increased prominence in last few years
  - NFA guidance has prescribed more proactive monitoring and follow-up
  - As a result, seeing more active inquiry from clearing firms in particular

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Commodity Pool / CPO Regulation (cont.)

- Commodity Pool (*CEA § 1a(10)*): "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests"
- Commodity Pool Operator ("CPO") (*CEA § 1a(11)*): "any person . . . Engaged in a business that is in the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property . . . for the purpose of trading in commodity interests"

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CFTC Rule 3.10(c)(3)

- For non-US firms, CFTC Rule 3.10(c)(3) may provide a registration exemption:
  - "A person **located outside the United States, its territories or possessions** engaged in the activity of . . . a commodity pool operator . . . in connection with any commodity interest transaction executed bilaterally or made on or subject to the rules of any designated contract market or swap execution facility **only on behalf of persons located outside the United States, its territories or possessions**, is not required to register in such capacity provided that any such commodity interest transaction is submitted for clearing through a futures commission merchant registered in accordance with section 4d of the Act."
  - Little interpretive guidance under this Rule from the CFTC

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“Not a Pool” Position

- Many proprietary trading firms that trade futures take the position that their business is not a “commodity pool,” and that CPO registration, therefore, is not implicated
  - Primarily derived from interpretation of no-action/interpretive guidance from the CFTC staff and the investor protection focus of CPO regulation
  - On this reading, the risk of being deemed a “pool” increases where:
    - Number of equity owners is large
    - “Insider” participation is expanded beyond key management/trading personnel
    - “Outside” participation is sought (particularly from passive investors or pooled investment funds)

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Alternative CPO Exemptions

- "Family Office" Exclusion – CFTC Letter No. 12-37 (Nov. 29, 2012)
- CFTC Rule 4.13(a)(3) "*de minimis*" exemption:
  - Limited futures trading permitted under this exemption
  - Requires a filing and annual affirmation
- CFTC Rule 4.13(a)(1) and (a)(2) exemptions
  - (a)(1) bars compensation (other than ordinary reimbursement) and only allows for operation of a single pool
  - (a)(2) caps total contributions to $400,000 and 15 investors (although there are carve-outs for certain principals and their families)
  - Both require a filing, annual affirmation and delivery of monthly brokerage statements to each investor

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Investment Adviser Regulation

- Not raised as often as CPO/pool issues
  - No analogous provision to NFA Bylaw 1101
  - "Aiding and Abetting"
- Investment Adviser: "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities"
- Limited SEC precedent, not helpful in articulating distinction between proprietary trading firms and advisory businesses

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Investment Adviser Regulation (Cont.)

- Practical Issues:
  - Is a proprietary trading firm (or its employees) engaged in the business of "advising others"?
  - Who is the "client" and who is the "adviser"?
  - What differentiates proprietary trading firms from institutional proprietary trading desks?
  - How would a proprietary trading firm measure its AUM?
    - "Private Fund" status
    - "Securities Portfolio"

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Non-US Firms

- Complete absence of US owners, investors and personnel could effectively moot this issue for some non-US firms
- When analysing regulatory exemptions for non-US investment advisers, SEC rules look both to where "clients" are located and where investment management activities take place:
  - Foreign Private Adviser Exemption: Self-effectuating exemption for firms with no US "place of business"
    - Must have fewer than 15 clients/investors in the US, and less than $25M in regulatory AUM attributable to such clients/investors
  - Private Fund Adviser Exemption: Exemption requires a notice filing with the SEC
    - Firm's only US clients are "private funds," and does not manage more than $150M of private fund assets from a place of business in the US

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“Family Office” Exclusion

- SEC has adopted a clear exclusion for “family offices” that could be applied to certain proprietary trading firms
- Key elements of definition:
  - “Client” restriction: No clients other than “family clients”
    - Permits “key employees”
  - Ownership restrictions: Wholly owned by “family clients”
  - Control restrictions: Controlled by “family members”
- These requirements limit the application of the “family office” exclusion to a number of firms

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Janet M. Angstadt

Janet M. Angstadt is the head of Katten Muchin Rosenman LLP's Chicago Financial Services practice. She focuses her practice on broker-dealer and exchange compliance issues and advises companies on matters regarding compliance with the regulations of the US Securities and Exchange Commission (SEC) and self-regulatory organisations (SROs).

Janet represents clients in a wide range of legal and regulatory matters, including mergers and acquisitions, SRO investigations, compliance issues related to registrations, sales practice, short sales, Regulation NMS, market-making and options and equities order handling. She advises on alternative trading systems, including dark pools and electronic communication networks, policies and procedures for trading systems development and testing and exchange-traded funds (ETFs).

Janet counsels large, full-service broker-dealers, exchanges and clearinghouses as well as firms with market-making, proprietary trading and algorithmic models. She also advises market centers on equities and derivatives market structure initiatives, including market access, market data, new products and SEC policy initiatives. In addition, Janet conducts independent compliance and technology reviews and audits related to enforcement action settlements.

Before joining Katten, she served as general counsel to NYSE Arca, Inc., an electronic equities and options exchange. As general counsel of NYSE Arca, Janet worked extensively on market structure and regulatory compliance issues and managed the company's membership and registrations departments. Prior to the merger of the New York Stock Exchange and Archipelago, she served as the deputy general counsel of Archipelago, where she created and implemented key company policies, including the company's procedures for development and testing of exchange technology. Janet also managed the compliance programs for Archipelago's four affiliated broker-dealers and played an integral role in legal and regulatory matters involving human resources, intellectual property and mergers and acquisitions, including Archipelago's acquisition of the Pacific Exchange and its merger with the New York Stock Exchange.

Earlier, Janet was senior vice president and counsel to the capital markets group of EVEREN Securities, Inc. She also was senior counsel for the SEC's Division of Market Regulation where she was a member of the three-person study team for the *Market 2000 Report*.

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Christian B. Hennion

Christian B. Hennion, a partner in Katten Muchin Rosenman LLP, concentrates his practice in financial services and asset management matters, including counseling fund managers, registered investment advisers and commodity trading advisors on both transactional and regulatory matters. Chris has advised a wide range of US and international managers, from start-ups to large institutions, regarding a variety of matters, including private fund launches and reorganisations, advisory engagements, Investment Advisers Act and Commodity Exchange Act compliance obligations, Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) registrations and examinations and related corporate and transactional matters. He is experienced with the preparation and negotiation of offering and advisory documents on behalf of asset management firms, as well as with the SEC and CFTC regulatory requirements and filings applicable to such firms.

During law school, Chris served as an executive articles editor of the *Chicago-Kent Law Review* and as a judicial extern to the Honorable Samuel Der-Yeghiayan of the US District Court, Northern District of Illinois.

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Carolyn H. Jackson

Carolyn Jackson is a partner in Katten Muchin Rosenman UK LLP and is a Registered Foreign Lawyer. She provides US financial regulatory legal advice to a broad range of market participants, including commercial banks, investment banks, investment managers, broker-dealers, electronic trading platforms, clearinghouses, trade associations and over-the-counter derivatives service providers.

Carolyn guides clients in the structuring and offering of complex securities, commodities and derivatives transactions and in complying with US securities and commodities laws and regulations. She is adept at addressing US registration issues for non-US entities looking to transact business into the United States, including clearing organisations and exchanges as well as asset managers and swap dealers. Having practiced outside of the United States for her entire legal career, she is particularly well versed in the cross-border effects of US regulations including the Dodd-Frank Act. She is a frequent speaker on topics including OTC derivatives regulatory reform and investment management regulation.

Prior to joining Katten, Carolyn was the European head of Allen & Overy LLP's US Regulatory Practice. Before becoming a lawyer, Carolyn was the executive director and a board member of the International Swaps and Derivatives Association, Inc. (ISDA). Carolyn spent the first 13 years of her career as a derivatives trader and was part of the original swaps team at Chase Manhattan Bank, NA. She established the New York derivatives trading desk for Banque Nationale de Paris, and was the first vice president and manager of the Banque Indosuez International Capital Markets Group in New York.

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Nathaniel Lalone

Nathaniel Lalone, a partner at Katten Muchin Rosenman UK LLP, has a broad range of experience in the regulation of financial products and financial markets, and frequently provides regulatory and compliance advice to trading venues, clearing houses and buy-side firms active in the over-the-counter (OTC) derivatives, futures and securities markets. He is actively involved in advising clients on the implementation of MiFID 2 and MiFIR in the European Union as well as the international reach of US financial services regulation. He also has significant experience with structuring and documentation relating to OTC derivatives and structured products.

Prior to joining Katten, Nathaniel was a member of the US Regulatory and the Derivatives and Structured Finance practices at Allen & Overy LLP.

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Neil Robson

Neil Robson, a regulatory and compliance partner with Katten Muchin Rosenman UK LLP, focuses his practice on counseling hedge and private equity fund managers, investment advisers, broker dealers and proprietary traders on operational, regulatory and compliance issues. He regularly addresses Financial Conduct Authority (FCA) and EU authorisation and compliance issues under EU directives, cross-border issues in the financial services sector, financial crime (including market abuse, money laundering and bribery), regulatory capital requirements, regulatory reporting and disclosure obligations, formations and buyouts of financial services groups, and structuring and marketing (financial promotions) of investment funds and other financial services products and securities.

Neil is often mentioned in the media and he is a frequent speaker at industry conferences regarding developments in UK financial services regulation, including the Alternative Investment Fund Managers Directive (AIFM Directive), MiFID II, short selling and market abuse.

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Lance A. Zinman

Lance Zinman serves as global co-chair of Katten Muchin Rosenman LLP's Financial Services practice and sits on the firm's Board of Directors and Executive Committee. Lance is a Registered Foreign Lawyer and a non-practicing partner in Katten Muchin Rosenman UK LLP. He represents hedge funds and commodity pools in all asset classes, private equity funds, investment advisers, commodity trading advisors and other asset managers. He also advises a broad cross section of proprietary trading firms—large and small—including many of the major firms in the industry. Lance's multidimensional skill set is unique, combining a deep understanding of corporate, regulatory, intellectual property and tax law, along with broad knowledge of the securities and derivatives markets. His extensive experience with these interconnected areas enables him to apply creative solutions to legal challenges, while also providing practical, common sense counsel.

Lance provides comprehensive legal services to institutional and emerging asset managers and proprietary trading firms in need of a single advisor who can assist them with all aspects of their business. He counsels them on a wide range of issues, including corporate formation structure, futures, derivatives, securities and other regulatory matters, trading issues, brokerage and derivatives documentation, tax planning, intellectual property matters, labor issues, equity and debt financings, mergers and acquisitions, joint ventures and seed deals. Originally a corporate attorney, Lance later joined the firm's Financial Services group, creating an efficiently integrated transactional and regulatory practice.

As a Chicago-based attorney, Lance has significant experience with volatility, algorithmic, low-latency and other trading strategies involving the use of futures, options and other derivatives. In addition, he counsels clients in other sectors of the financial markets, including domestic and foreign exchanges, brokerage firms, swap counterparties and other participants in over-the-counter transactions. Lance also advises clients that are looking to establish a presence internationally or trade directly on foreign exchanges.

Separately, he represents clients in the entertainment and sports industries as well, including the Chicago Bulls, Chicago White Sox and Oakland Athletics.

Lance is frequently tapped to speak at events on topics relating to hedge funds and proprietary trading, including Managed Funds Association (MFA) conferences and the SkyBridge Alternatives conference (SALT). Crain's Chicago Business selected Lance for its prestigious 2012 "40 Under 40" list describing him as "a rare lawyer under 40 atop a big firm practice." Lance was also named one of "40 Under 40 to Watch" in 2008 by the Chicago Daily Law Bulletin which noted that his "breadth and depth of experience have led his clients to describe him as one of the city's top business lawyers." In 2009, he was one of six attorneys to be named the "Next Generation of Leaders" by Chicago Lawyer magazine.

Lance is also on the global board of directors of Hedge Funds Care, an international charity supported by the hedge fund industry dedicated to the prevention and treatment of child abuse.

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Katten Muchin Rosenman UK LLP

Katten Muchin Rosenman LLP Locations

AUSTIN
One Congress Plaza
111 Congress Avenue
Suite 1000
Austin, TX 78701-4073
+1.512.691.4000 tel
+1.512.691.4001 fax

CHARLOTTE
550 South Tryon Street
Suite 2900
Charlotte, NC 28202-4213
+1.704.444.2000 tel
+1.704.444.2050 fax

CHICAGO
525 West Monroe Street
Chicago, IL 60661-3693
+1.312.902.5200 tel
+1.312.902.1061 fax

HOUSTON
1301 McKinney Street
Suite 3000
Houston, TX 77010-3033
+1.713.270.3400 tel
+1.713.270.3401 fax

IRVING
545 East John Carpenter Freeway
Suite 300
Irving, TX 75062-3964
+1.972.587.4100 tel
+1.972.587.4109 fax

LONDON
Paternoster House
65 St Paul's Churchyard
London EC4M 8AB United Kingdom
+44.0.20.7776.7620 tel
+44.0.20.7776.7621 fax

LOS ANGELES – CENTURY CITY
2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
+1.310.788.4400 tel
+1.310.788.4471 fax

LOS ANGELES – DOWNTOWN
515 South Flower Street
Suite 1000
Los Angeles, CA 90071-2212
+1.213.443.9000 tel
+1.213.443.9001 fax

NEW YORK
575 Madison Avenue
New York, NY 10022-2585
+1.212.940.8800 tel
+1.212.940.8776 fax

ORANGE COUNTY
100 Spectrum Center Drive
Suite 1050
Irvine, CA 92618-4960
+1.714.966.6819 tel
+1.714.966.6821 fax

SAN FRANCISCO BAY AREA
1999 Harrison Street
Suite 700
Oakland, CA 94612-4704
+1.415.293.5800 tel
+1.415.293.5801 fax

SHANGHAI
Suite 4906 Wheelock Square
1717 Nanjing Road West
Shanghai 200040 P.R. China
+86.21.6039.3222 tel
+86.21.6039.3223 fax

WASHINGTON, DC
2900 K Street NW
North Tower - Suite 200
Washington, DC 20007-5118
+1.202.625.3500 tel
+1.202.298.7570 fax

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Katten Muchin Rosenman UK LLP