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Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Launching an Exempt Structured Products Program in the United States: Issues for Non-U.S. Banks to Consider

Non-U.S. banks that maintain a registered medium-term note program may wish to supplement that platform with an exempt bank note program for issuances of structured products. Other non-U.S. banks may wish to make the plunge into the U.S. market for the first time. Alternatively, a non-U.S. bank may have an existing exempt program, but has never contemplated using that program for issuances of structured products. In this article, we summarize the key issues to be considered prior to launching an exempt structured products program.

Which exemptions are available, and is there any advantage to using any particular exemption?

Foreign banks may avail themselves of three exemptions from registration under the Securities Act of 1933 (the "Securities Act"). Rule 144A under the Securities Act ("Rule 144A") and Regulation D under the Securities Act ("Regulation D") are both transactional exemptions available to a non-U.S. bank or any other issuer, regardless of its business.[1] Regulation D is a safe harbor for private placements under Section 4(a)(2) of the Securities Act. There are significant restrictions on transfer and resale for Rule 144A or Regulation D securities.

[1] In this article, we refer to issuers using the Rule 144A and Regulation D exemptions as "foreign banks," which term includes foreign financial institutions that may not be organized as a bank.

Section 3(a)(2) under the Securities Act is an exemption for securities issued or guaranteed by a "bank." It is available for securities issued by certain U.S. branches or agencies of a foreign bank, but not to the securities of the foreign bank, except as discussed below.[2] The Securities and Exchange Commission (the "SEC") deems a branch or agency of a foreign bank located in the United States to be a "bank," as defined in Section 3(a)(2), provided that the nature and extent of federal and/or state regulation and supervision of the particular branch or agency is substantially equivalent to that applicable to U.S. federal or state banks doing business in the same jurisdiction.

The securities of a foreign bank are exempt under Section 3(a)(2) if they are guaranteed by a bank. Many non-U.S. banks use this structure by having the U.S. branch or agency guarantee securities issued by the non-U.S. headquarters or branch. Another alternative is to have the U.S. branch or agency act as the guarantor for securities issued by a finance subsidiary of the foreign bank. The guarantee is a legal requirement to qualify for the exemption; investors will typically not be looking to the U.S. branch or agency for payment, but rather to the home office. The guarantee must be full and unconditional.

Section 3(a)(2) bank securities have no investor or resale limitations, except as discussed below. Section 3(a)(2) bank securities are generally freely transferrable and "public," as opposed to "private" securities issued under the Rule 144A or Regulation D transactional exemptions.

Why might a non-U.S. bank consider an exempt program in addition to an existing public program?

Any bank that already issues under a registered program may consider whether an exempt program would simply be redundant, or actually provide benefits to it. Among the reasons why many issuers maintain an exempt program in addition to their registered program are:

- Particularly in the Rule 144A market, some investors wish to keep the terms of the securities that they purchase confidential, which is not feasible in connection with a registered offering.
- Some types of underlying assets are not contemplated by the SEC's "Morgan Stanley letter" relating to registered structured notes, including credit-linked notes and small-capitalization stocks.
- Practitioners generally believe that the potential for federal securities law liabilities in the event of a misstatement or omission in the offering documents is somewhat reduced in the case of an exempt offering. This feature might be particularly attractive in the case of complex securities or complex underliers that are used in an offering sold to institutional investors.

Does the foreign bank need to consult with any U.S. regulator prior to launching the program?

A foreign bank issuing under the Rule 144A exemption or the Regulation D safe harbor would not have to consult with, or be regulated by, any U.S. regulatory entity prior to issuing its securities, nor would it have to use a U.S. branch or agency to issue under those exemptions.

A U.S. branch or agency of a foreign bank should consult with its state and federal regulator prior to launching a structured product program. U.S. branches or agencies that have chosen to be regulated as a state bank (typically in New York) should consult with their state banking regulator, the New York State Department of Financial Services (the "NYDFS"), and the Federal Reserve Bank of New York.

There are no formal federal or New York state bank regulatory application, registration or notification requirements for the issuance of notes by a New York branch. However, advance consultation with the NYDFS on any structured notes

[2] For an extensive discussion of Section 3(a)(2) bank note programs, please see our FAQ at http://www.mofo.com/capital-markets-services/?op=richTextB&ajax=no.

program should be considered. The NYDFS may want the opportunity to review these types of programs, and to approve/not object to the terms and conditions of the program or a proposed offering.[3]

Branches or agencies in other states should contact their state and federal regulators.

If the U.S. branch's or agency's primary regulator is the Office of the Comptroller of the Currency (the "OCC"), the program must comply with 12 C.F.R. Part 16, the OCC's Securities Offering Disclosure Rules (the "OCC Rules"), as more fully discussed below. U.S. branches or agencies that have elected to be federal branches or agencies are regulated by the OCC.

An uninsured state-regulated U.S. branch of a foreign bank is subject to the deposit regulations of the International Banking Act of 1978, as amended.[4] Some types of notes issued by a state-regulated U.S. branch of a foreign bank could be viewed as a "deposit" by the branch's state or federal regulators within the meaning of Section 3(l) of the Federal Deposit Insurance Act.[5] In order to avoid being considered a prohibited retail deposit of an uninsured domestic branch of a foreign bank, those types of deposits cannot be offered in denominations that are less than the "standard maximum deposit insurance amount," which is currently $250,000.[6] This limitation does not apply to notes issued by a foreign bank and guaranteed by its U.S. branch, and accordingly, that structure is more typically used for programs that are not planned to be limited to institutional investors.

Comparable requirements are applicable to an uninsured U.S. branch that is regulated by the OCC under the OCC's deposit-taking rules.[7] These restrictions are subject to a variety of exceptions set forth in the OCC's rules. The OCC is also authorized to grant exemptions to these limitations if the branch can demonstrate that the proposed activity is consistent with the policy described in 12 C.F.R. § 28.16(a).

Are there any restrictions on investors?

Foreign banks and U.S. branches or agencies issuing notes under Rule 144A must sell only to "qualified institutional buyers," as that term is defined in Rule 144A(a)(1) ("QIBs"). Sales to individual retail investors are prohibited. Notes sold under Rule 144A also have significant restrictions on transfer; resales to other QIBs are allowed, but transfers to non-QIBs are subject to significant restrictions, which often prevent these transfers from occurring.[8] General solicitation can now be used in a Rule 144A offering, but sales can only be made to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.[9]

Foreign banks and U.S. branches or agencies issuing structured notes under Rule 506 of Regulation D can sell to an unlimited number of "accredited investors," as that term is defined in Rule 405 under the Securities Act, and up to 35 non-accredited investors who meet certain "sophistication" requirements,[10] if the appropriate resale limitations are imposed, any applicable information requirements are satisfied and the other conditions of the rule are met. General solicitation is now permitted in certain Rule 506 offerings, provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors. A foreign bank can opt to issue structured notes under Rule 506 without using general solicitation.

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[3] See also the note below on issuances by New York agencies.
[4] 12 U.S.C. § 3104(c)(1).
[5] In the past, the FDIC stated that it believed that certain types of bank notes issued by insured depository institutions, such as instruments marketed as "deposit notes," fall within Section 3(l)(1) of the Federal Deposit Insurance Act. See 60 Fed. Reg. 66,952 (1995). In contrast, the FDIC has stated that a bank product that is structured as a non-principal protected instrument (like most (but of course, not all) structured notes) is a non-deposit obligation of the bank. See Letter of Joseph A. Genova Jr., FDIC Senior Regional Attorney to Bankers Financial Services Corporation (February 27, 2002; available at https://www.indexedcd.com/bankers/public/datafiles/regulatory_review_fdic_insurability.pdf).
[6] 12 C.F.R. §§ 347(e), (v).
[7] 12 C.F.R. § 28.16.
[8] For a detailed discussion of Rule 144A programs, please see our FAQ at http://www.mofo.com/capital-markets-services/?op=richTextB&ajax=no.
[9] To date, structured note issuers have not made much use of general solicitation in Rule 144A offerings.
[10] Under Rule 506(b)(2)(ii), each purchaser in a Rule 506 offering who is not an accredited investor must possess, or the issuer must reasonably believe before the sale of the securities that such purchaser possesses, either alone or with his or her purchaser representative, "such knowledge and experience in financial or business matters that he [or she] is capable of evaluating the merits and risks of the proposed investment." Generally, issuers of structured products using the Rule 506 exemption do not offer or sell securities to non-accredited investors.

Whether or not general solicitation is used in a Rule 506 offering, the new "bad actor" disqualification provisions will apply. These provisions prohibit issuers and others such as underwriters, placement agents, directors, executive officers, and certain shareholders of the issuer from participating in a Rule 506 offering if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws.[11]

Structured notes issued under Rule 144A or Rule 506 of Regulation D are "restricted securities," as that term is defined in Rule 144(a)(3) under the Securities Act, and are subject to restrictions on resale.

There are no minimum denomination requirements for a Rule 144A or Rule 506 offering of structured notes; however, concerns about preventing confusion between bank deposits and deposit products and bank notes may cause banks to issue in denominations of at least $1,000. In addition, many bank notes are issued in higher denominations, in order to help address investor suitability concerns.

A U.S. branch or agency that is regulated by a state, rather than the OCC, can issue Section 3(a)(2) bank notes to all investors, including retail. However, an agency of a foreign bank subject to New York state banking regulations would have to notify the Superintendent of the NYDFS of the upcoming transaction, and, absent objection from the Superintendent within 30 days of such notice, would be able to sell only to certain authorized institutional purchasers in minimum denominations of $100,000.

Under the OCC Rules, a federal branch or agency can issue bank notes under any of three exemptions from the OCC's registration requirements:

- Part 16.6 of the OCC Rules provides for issuances of non-convertible "investment grade" debt to accredited investors, in $250,000 minimum denominations, subject to certain disclosure requirements and a post-sale filing. Any resale of a bank note under Part 16.6 must be in a minimum denomination of $250,000.

- Part 16.5 provides exemptions for issuances of securities under Rule 144A or Regulation S under the Securities Act.

- Part 16.7 provides an exemption for issuances of securities under Regulation D.

Issuances of structured bank notes by a federal branch or agency under Rule 144A or Regulation D in compliance with the OCC Rules would be subject to the restrictions on the manner of offering, and the OCC's deposit-taking rules, each as discussed above.

What type of financial statements are required in the disclosure documents?

General. There are several threshold questions about financial statement requirements, and the answers will depend on the identity of the issuer and the exemption used for the issuance. For example, a foreign bank issuing structured notes in the United States under Rule 144A or Rule 506 would use its own financial statements. Preferably, the financial statements should be in English, audited, in a form understandable to U.S. investors and publicly available. U.S. GAAP or IFRS are the choices that are most widely used in the U.S. market. In registered offerings, financial statements prepared under other accounting principles need to include a U.S. GAAP reconciliation footnote, and the bank and its distributors may wish to consider whether this is a desirable step for a non-registered program. For a continuous offering program, the bank should also publish unaudited financial statements, at least on a semi-annual basis. The statistical disclosures required in a registration statement by Industry Guide 3, Statistical Disclosure by Bank Holding Companies, may also be desirable to include.

Often, the most convenient situation would be if the foreign bank could incorporate its audited financial statements from a Form 20-F or 40-F filed with the SEC.[12] Although not required for an exempt offering, issuers incorporating their financial

[11] For a detailed description of the bad actor provisions applicable to Rule 506 offerings, please see our Client Alert.
[12] This would be the case for a foreign bank that currently maintains a shelf registration statement, and wishes to supplement its registered offerings with an exempt platform.

statements from a Form 20-F may wish to ensure that the Form 20-F is filed prior to the financial statements becoming more than 15 months old.[13]

An alternative would be if the foreign bank's audited annual financial statements (and unaudited semi-annual or quarterly financial statements), meeting the requirements of its home jurisdiction, are posted and regularly updated on a website or an electronic delivery system generally available to the public in its primary trading market. Those financial statements can be incorporated by reference into the offering document.

Because a U.S. branch or agency will not have its own financial statements, market practice is to use the financial statements of the parent foreign bank, as they are recognized as one enterprise.

In all situations, the lead distributor for the proposed structured notes program should be consulted as to the form of the financial statements. Variations from the use of a Form 20-F or 40-F, and from U.S. GAAP or IFRS, may raise concerns with the distributors.

Rule 144A Offerings. Foreign banks, and U.S. branches or agencies of a foreign bank, issuing structured notes under Rule 144A, in each case not subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") nor exempt from reporting under Rule 12g3-2(b) thereunder, must make available to any purchaser of a structured note and a prospective purchaser designated by the holder the financial information required by Rule 144A(d)(4). That information includes financial statements for the last two fiscal years, which should be audited to the extent reasonably available.

Part 16. Federal branches and agencies using the OCC Part 16.6 exemption must provide the OCC with the information specified in Rule 12g3-2(b) under the Exchange Act and provide investors with the information required by Rule 144A(d)(4)(i).

Regulation D. Foreign banks, or U.S. branches or agencies thereof, issuing under the Rule 506 exemption (including issuances by federal branches or agencies under OCC Part 16.7) to non-accredited investors must satisfy the requirements relating to financial and other information to be provided to non-accredited investors included in Rule 502(b) under the Securities Act. As noted above, this step can cause offerings to these types of investors to be impractical or expensive, and are not common in the structured note market.

What regulatory issues arise from using a New York branch as the issuer, as opposed to acting as the guarantor?

While there are no specific rules on how New York branches of foreign banks may use the proceeds of their funding activities, Federal and New York bank regulatory authorities will want to understand the purpose of the issuances, where and how the funds will be used, and how the market risks will be hedged. In addition, regulators are likely to closely scrutinize any proposal to repatriate to the home office the proceeds of any funding activities, including the proceeds of notes issued by a New York branch. Federal and state authorities routinely monitor the exposures of U.S. branches to their home offices and may raise supervisory questions if those exposures become excessive. These determinations are made on a case-by-case basis.

The NYDFS currently does not have rules or regulations imposing limits on on-lending. However, the NYDFS has an informal policy that may limit the amount it may be owed by its head office or any other affiliate to 50 percent of the assets of any branch or agency.

The NYDFS has stated that it no longer strictly applies the on-lending policy to limit the size of net due from head office accounts of New York state-licensed branches and agencies. Rather, the NYDFS applies the policy only to prohibit the use of a New York branch license solely as a funding vehicle for a bank's head office, and as a tool to monitor the asset quality of the branch or agency, especially in light of concentration of country exposure. If the institution of the head office

[13] See Item 8.A.4 of Form 20-F. This is a requirement for offerings for registered securities, and depending upon the nature of the program, the dealers may expect that the financial statements available to purchasers in an exempt offering be just as "fresh."

is strong, the NYDFS is likely to be less concerned with a large amount due from the head office. A bank that plans to substantially increase its due from the head office because of on-lending of funds raised in the capital markets may wish to discuss the matter in advance with the NYDFS.

New York branches of foreign banks are also subject to asset segregation requirements that are intended to ensure the ability of the New York branch to satisfy its covered liabilities. In turn, any notes issued or guaranteed by a New York branch would presumptively be considered liabilities for purposes of these financial regulatory requirements.

The NYDFS also will want to understand how the market risks arising from the notes will be hedged, and by which entity. Consideration should be given to whether the branch has the authority to carry a hedge book, and whether the branch has systems in place to hedge. Does the branch have people experienced in derivatives transactions and analyzing risk? Who will be the hedging counterparties? Hedging transactions should also be analyzed to avoid any violation of the affiliate transaction restrictions of Sections 23A and 23B of the Federal Reserve Act, should a hedging counterparty be an affiliate of the bank.

How early in the process should the issuer choose a lead dealer for the program?

Very early. Many banks have an affiliated broker-dealer that will be part of a structured note program. That affiliated dealer may or may not have expertise in the structured products market. If the affiliated dealer is unfamiliar with the structured products market and the related distribution and sales issues, the issuer will likely seek to engage an unaffiliated dealer that is familiar with the structured products market, for the following reasons:

- The Financial Industry Regulatory Authority, Inc. (“FINRA”) and a variety of other U.S. regulators are focused on the suitability of sales of structured products, particularly to retail investors. An issuer will benefit from engaging a dealer that has experience in the structured products market, and that has established internal compliance procedures to ensure that its sales of structured products do not violate FINRA’s suitability rule.

- The dealer may have particular views and preferences with regard to acceptable financial statements (as discussed above) and forms of documentation (as discussed below). It is better to take into account the dealer’s preferences and suggestions early in the process instead of completing documentation that is later found to be unacceptable to unaffiliated dealers due to market practices and preferences.

- If the dealer plans to distribute through third-party broker-dealers that will not be signed up as dealers on the structured note program, the issuer should inquire as to the dealer’s “know your distributor” practices and procedures, with a view to preventing any future reputational risk.

- The available FINRA filing exemption will depend on whether an affiliated or unaffiliated broker-dealer is used for the program, and whether “conflicts of interest” (as defined by FINRA) disclosure should be included in the offering circular.

- The lead dealer will want to start its diligence early in the process in order to identify any potential issues, whether relating to the issuer’s creditworthiness, disclosures in the offering documents, or other areas.

What types of documents are needed for the program?

Although the names are different, the documentation for a structured bank note program is similar in many respects to that in a registered offering:

- *Offering Circular*: Because an exempt offering is subject to the anti-fraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, the information in an offering circular tends to be consistent with that in a prospectus for a registered offering, even though there is no specific content requirement under the Securities Act or the banking regulations. At a minimum, the offering circular should contain the information required for an offering by a national bank under OCC Part 16.6—a description of the business of the issuer similar to that contained in a Form 10-K, a description of the terms of the bank notes, the use of proceeds and the method of distribution.

- Disclosure about a branch or agency will be very limited, and often consists of only the address, primary business lines and date of establishment. Because the branch or agency is the same legal entity as the parent or headquarters, disclosure about the parent or headquarters is typically sufficient.
- If a guarantee structure is used, the terms of the guarantee must be fully disclosed.
- Structured notes issuers also may use forms of "product supplements" for particular structures, and a "pricing supplement" containing the terms of a particular note being offered.

- *Distribution Agreement*: This document would also be very similar to a distribution agreement for a registered offering. Here, early contact with the lead dealer will be helpful in identifying a form that is acceptable for that dealer and that is also market standard. The issuer should not necessarily attempt to make this document too "issuer-friendly" if, for example, the lead dealer is an affiliate of the issuer. Doing so may make it difficult to add third-party dealers in the future.
  - Careful consideration should be given to the comfort letters and the scope of legal opinions to be delivered at the commencement of the structured notes program and also on a periodic basis. Usually, an annual comfort letter that occurs shortly after the issuance of the audited financial statements will be delivered, and semi-annual or quarterly comfort letters will be delivered after the issuance of the periodic, unaudited financial statements. The opinions delivered, usually on a quarterly, semi-annual or annual basis, will cover corporate matters (e.g., due incorporation, no conflicts, no litigation), regulatory matters (compliance with banking regulations, no registration required under the Investment Company Act of 1940 (the "1940 Act")) and also include a Rule 10b-5 disclosure statement.
  - Counsel should be consulted early on in the process in order to negotiate the scope of the opinions, and to sort out delivery of the opinions between internal and external counsel. Internal counsel may not be comfortable giving certain opinions, while external counsel, if not regularly engaged by the issuer, may not be in a position to give one or more of the corporate opinions described above. For example, the due incorporation, no conflicts, no litigation and regulatory compliance opinions are often given by internal counsel, while the opinions on the availability of the securities or transactional exemption and the 1940 Act exemption are often delivered by external counsel.
  - Does the issuer have a designated underwriters' counsel? If so, and if they are going to play a role in the structured products program, they, too, should be consulted early on in the process. They will provide comments on, and have a view about, the program documentation. If the issuer is new to the structured notes market, they may want to designate underwriters' counsel to help guide them through the process. Designated underwriters' counsel may be required to deliver a letter as to the absence of misstatements or omissions in the offering documents.
  - The issuer should plan for regular periodic diligence sessions, involving document review by outside counsel and telephonic meetings with the dealers. The issuer's financial and legal teams should be available to discuss financial, legal and regulatory issues. These diligence sessions are normally conducted immediately after the publication of the issuer's annual and periodic financial statements.
- *Paying Agency Agreement*: The issuer should identify the party that will be the paying agent for the bank notes. Some issuers use an affiliated bank for this purpose. The form of paying agency agreement will typically be specified by the paying agent, with some input from the lead dealer.

- *Drafting Process.* As a threshold matter, the issuer should identify the correct entities and individuals within its organization to be tasked with reviewing documents, with a goal to avoid last minute changes required by a particular internal group or department that has not been consulted.

Conclusion

There is a lot of spadework to be done by a foreign bank prior to launching an exempt structured products platform in the United States. Issuers would be well served to work with their counsel and planned distributors early in the process to identify the necessary steps and required action items.

"Big-Boy Letters" Revisited: *Pharos* Decision Upheld by the Sixth Circuit

Introduction

In our December 18, 2012 issue of *Structured Thoughts*, we examined a district court case that addressed the effectiveness of "Big-Boy Letters" in connection with a private sale of securities.[14] "Big-Boy Letters" contain, among other provisions, representations that the investor is a sophisticated party that does not need to rely on the issuer of the relevant product or on the issuer's agent. Additionally, these letters frequently include a waiver of all claims against the seller alleging the nondisclosure of non-public information about the issuer that may be known by the seller.

There has been some question as to the enforceability of Big-Boy Letters, because waivers of liability for securities fraud are void under Section 29(a) of the Securities Exchange Act of 1934. However, in October 2012, the district court in *In re Nat'l Century Fin. Enterprises, Inc., Inv. Litig.*, 905 F. Supp. 2d 814 (S.D. Ohio 2012) ("*Pharos*") granted summary judgment in favor of the defendant, Credit Suisse Securities, LLC ("Credit Suisse"), which was a placement agent in a private placement of securities that lost their full value. The court held that the parties' Big-Boy Letter negated an element of the investor plaintiff's, Pharos Capital Partners ("Pharos"), claim for securities fraud. The language of the letter was found to preclude a finding of justifiable reliance on the part of Pharos. As justifiable reliance is a necessary element of a successful fraud claim, the court granted Credit Suisse's motion for summary judgment.

Sixth Circuit Review

In an October 2013 per curiam opinion, the Sixth Circuit Court of Appeals reviewed and roundly upheld the district court's decision in *Pharos*. The Sixth Circuit court found that the district court correctly held that Pharos could not justifiably rely on any statement made by Credit Suisse, because Pharos was a sophisticated investor and had signed a Big-Boy Letter explicitly disclaiming such reliance.[15] In addition, the court highlighted that Pharos had failed to present any particular evidence of reliance or evidence that Credit Suisse had knowledge of material information that could not be uncovered by an outside investor.[16]

This decision illustrates the utility of using carefully drafted Big-Boy Letters in connection with the offering of sophisticated structured products. A Big-Boy Letter will not waive liability for securities fraud, but it can eliminate a critical element of such a claim and thereby reduce the liability risk for issuers and underwriters involved in these offerings.

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[14] Volume 3, Issue 14 of Structured Thoughts (available at http://www.mofo.com/files/Uploads/Images/121218-Structured-Thoughts.pdf).
[15] *Pharos Capital Partners, L.P. v. Deloitte & Touche*, 12-4381, 2013 WL 5733828 (6th Cir. Oct. 23, 2013).
[16] *Id.* at *1, *2.

SEC Addresses Potentially Misleading Fund Names

In recent years, the SEC's Division of Corporate Finance and Office of Capital Market Trends have addressed issues relating to potentially misleading names for structured notes. This issue was particularly relevant to notes with a name that included a phrase such as "principal protected."

Now, it's the Division of Investment Management's turn. The division is addressing funds using names that suggest safety or protection from loss.

In Guidance Update No. 2013-12, the staff stated that fund names suggesting safety or protection from loss may contribute to investor misunderstanding of investment risks. The staff said that it recently requested that some existing and new funds change what it believes were misleading names. The staff encourages funds that expose investors to market, credit or other risks, and whose names suggest safety or protection from loss, to reevaluate their names.

In particular, the staff raised concerns about funds with names that include the terms "protected," "guaranteed" and the like, when used "without additional qualification." High on the staff's watch list are funds that use the term "protected" in their names and seek to manage volatility by investing a portion of their assets in cash, short-term instruments or short positions on exchange-traded futures.

Funds that offer third-party principal protection against NAV shortfall also concern the staff. The staff said that funds that contract with third parties to make up NAV shortfalls should not use the term "protected," unless the fund's name adequately communicates the limitations of the "protection." It is not enough, the staff cautioned, merely to disclose the limitations of third-party protection in the text of the prospectus. Rather, the name itself must reveal those limitations.

In conclusion, the staff encouraged investment advisers and funds' boards of directors to carefully evaluate any fund name that suggests safety or protection from loss. These funds may consider whether a name change is appropriate to address any potential for investor misunderstanding.

What to Expect in 2014?

Over the last few years, we all have become fairly adept at expecting and addressing the unexpected; however, it still remains useful at year-end to consider what's on the horizon. Here are our thoughts on what to expect in the structured products area in 2014.

Dodd-Frank-Related Developments

The Volcker Rule: Probably the most anticipated (or dreaded) rulemaking, the Volcker Rule was expected in December 2013, but it now seems more likely that we will see a new rule in early 2014. Although the Volcker Rule is not specifically focused on structured products, it will have an effect on this market. The rule will affect the ability of broker-dealers to maintain an inventory of structured products for market-making purposes or to accommodate clients who would like to trade in or out of structured products issued by the broker-dealer's affiliated public bank holding company parent.

Section 621 of the Dodd-Frank Act: This is the neglected "step-child" to the Volcker Rule, which addresses conflicts of interest. Back in 2011, the SEC released a proposed rule (Rule 127B of the Securities Act) to implement the Dodd-Frank provision. The proposed rule would generally prohibit certain persons involved in the structuring, creation and distribution of an asset-backed security from engaging in transactions within one year after the date of the first closing of the sale of such ABS that would involve or result in a material conflict of interest with respect to any investor in such ABS. Depending on the ultimate definition of "asset-backed security" for these purposes, certain structured products may be covered by the rule's prohibition on conflicts.

Title VII: We recently wrote about the effect of Title VII on the hedges associated with structured product issuances (http://www.mofo.com/files/Uploads/Images/131015-Structured-Thoughts.pdf). The CFTC has finalized most of the rules relating to swaps. We anticipate that we will have greater clarity in 2014 from the SEC relating to the rules applicable to security-based swaps.

CPOs: Although the Staff of the CFTC has provided guidance on various types of vehicles that should not be viewed as commodity pools, it is still necessary to consider each existing or proposed structure that uses a trust or other collective investment vehicle to offer structured products in which the trust engages in swaps activities. The CFTC exemptive relief stops short of addressing trusts that are used to issue credit-linked or insurance-linked notes, so these transactions merit special attention.

Removing References to Ratings: One of the objectives of the Dodd-Frank Act was to ensure that regulations did not incorporate references to credit ratings as that might cause undue reliance by investors and others on ratings. The banking agencies and the SEC have amended many of their rules to eliminate references to ratings; however, this task has not been completed. For example, the SEC has not finalized amendments to Regulation M to eliminate ratings. We discussed the SEC's proposals in a prior issue (http://www.mofo.com/files/Uploads/Images/110620-Structured-Thoughts.pdf). Depending on the reformulation, this may have an effect on structured products offerings, such as variable price re-offer deals.

Fiduciary Duty: The SEC (and the securities industry) remains focused on finalizing the duties of care of broker-dealers. The Dodd-Frank Act required that the SEC consider the appropriateness of imposing a fiduciary duty or heightened duties on broker-dealers. Following discussions regarding the many comment letters submitted to the SEC by industry groups, there is little consensus regarding the types of additional duties that may be imposed on broker-dealers. However, November 2013's vote of the SEC Investor Advisory Committee to recommend that the SEC adopt fiduciary duties on broker-dealers increases the likelihood of significant changes. In the structured products world, where most of the issuers rely on their affiliated broker-dealers to structure, distribute and hedge notes, and many notes are distributed through proprietary channels, the imposition of a fiduciary duty would have a disparate impact.

Bank Capital and Related Rules: The U.S. banking agencies continue to work to finalize the rules implementing the Basel III framework in the United States. Given that U.S. issuers of structured products are financial institutions subject to the regulatory capital rules, and some buyers of structured products are insurance companies also subject to certain of these rules, the incentives or disincentives created by this framework may have an effect on the market.

FINRA Developments

FINRA remains keenly focused on the structured products market, and during this past year FINRA has issued various investor alerts and regulatory notices that relate to structured products. In 2014, we anticipate that FINRA will continue to emphasize:

The Importance of KYD: Given that distributors are interacting with retail clients, FINRA has noted that issuers and their affiliated broker-dealers must conduct appropriate diligence of their distributors.

Suitability Determinations and Policies: FINRA has provided additional guidance in the form of FAQs and also its perspective on effective suitability policies. We anticipate that FINRA will pay close attention to the policies and procedures developed by member firms, especially for "complex products."

Conflicts of Interest Policies and Disclosures: FINRA's recent report on its conflicts of interest review is likely only the first of many communications on this topic. In the report, FINRA advises that it will be monitoring broker activities in this area, and will consider additional regulations, if needed.

Reverse Inquiry: Offerings that begin their lives as reverse inquiry transactions and then are more broadly offered and sold seem to be an area that is under scrutiny.

Heightened Duties in Respect of Complex Products: In all of its communications, FINRA reminds member firms that they have heightened duties when recommending complex products. It is unlikely that FINRA will provide any more detailed guidance, beyond that provided in notice 12-03, on particular products that it views as "complex."

Member firms should review, among other things: (1) Their KYD policies and procedures; (2) their new product approval process to make sure that it addresses issues specific to complex products as well as conflicts of interest; (3) their suitability policies and procedures, as well as training segments that discuss suitability obligations; and (4) ensure that for offerings that started as a reverse inquiry before broadening the offering to include retail investors, there is a process in place to confirm that the offering would be appropriate for a retail investor.

Performance Data: We are hopeful that FINRA will provide guidance on the use of performance data in marketing materials. As we have discussed before (http://www.mofo.com/files/Uploads/Images/130426-Structured-Thoughts.pdf).FINRA does not permit the use of hypothetical historical index performance data in marketing material; however, this data may be included in "issuer materials." Needless to say, this leads to anomalous results.

144A Data: the SEC has approved FINRA's rule change to permit the dissemination of trade data through the TRACE system for 144A offerings. It is not clear when this change will take effect, but it may lead to greater transparency for structured product offerings completed on a 144A basis.

Other SEC Developments

Above, we mention a number of rulemakings required to be undertaken by the SEC and/or other agencies. In addition to those mandatory rulemakings, we would expect that the SEC will continue to monitor estimated value and other disclosures in structured product offering documents, and in some cases, suggest revisions. We also anticipate that the SEC's Office of Compliance Inspection and Examinations (OCIE) may ask broker-dealers active in the area about their policies and procedures in calculating estimated value or pricing structured products.

PRIPs

Following a European Parliament vote in November 2013 on the proposed PRIPs regulation, trilogue negotiations between the European Parliament, the Council of the European Union and the European Commission are expected to begin in 2014 under the Greek Presidency of the Council.

The PRIPs regulation is intended to harmonise the disclosure and transparency requirements for the offering of retail investment products (including products issued in the form of securities, fund interests, deposits and life assurance polices) by requiring the production of a short, highly standardised disclosure document (called a "Key Information Document" or "KID") to aid comparison of different products originating from different financial industry sectors.

Following the draft EU Commission Regulation on PRIPs published in July 2012, compromise drafts have been published by the Council and in November 2013, a draft has been approved by the EU Parliament. There are significant differences between the various drafts that need to be addressed in the trilogue.

Of particular focus during the trilogue negotiations will be the following proposals:

- *scope* – the EU Commission and Council draft definitions of "investment product" move away from the requirement for there to be "packaging" of the product but still envisage indirect exposure to some type of underlying asset or index. The EU Parliament draft proposes that investment products generally be in the scope of the definition with an exemption for certain vanilla products.

- *liability for the KID* – this will attach to the product manufacturer (with a possible "product seller annex" containing information for which the product seller will be responsible). Still to be agreed are the burden of proof as to liability and whether this will fall on the investor or the product manufacturer.

- *length* – proposed maximum length of two double-sided A4 pages, plus the seller annex.

- *content* – in addition to the European Commission proposals, suggestions of inclusion of a “complexity label” for complex products, and a link to an online fund calculator for investors to calculate the end value of their investment, after fees and costs. Discussion also as to whether the KID is to be “standalone” or is envisaged as a summary document to be considered in conjunction with a prospectus or other similar document.

- *other product regulation proposals by the EU Parliament* – a product approval process adopted by the manufacturer to ensure compatibility of the product and its target market, new product intervention powers for regulators, a risk management process to be adopted by the manufacturer to measure and monitor the product’s risk profile at any time, restrictions on the structure and methodology of the product’s payoff.

MiFID

The proposed MiFID II Directive and MiFIR Regulation are currently scheduled to be considered at the EU Parliament’s plenary session to be held between 9 and 12 December 2013.

- Most relevant to structured products will be provisions relating to:
- increased investor protections
- increased product intervention powers for regulators
- required exchange trading of certain products deemed sufficiently liquid
- greater regulatory capture of different trading venues
- pre-trade transparency for traded structured products and derivatives
- market access for non-EEA firms for provision of financial services and products

EMIR

Although parts of the EMIR regulation are already in force, the main provisions relating to compulsory clearing of certain classes of OTC derivatives require further rulemaking and determinations by the European Commission and the European Securities Markets Authority, which are expected during the course of 2014. In addition, the compulsory reporting of derivatives trades to repositories will become effective in February 2014.

Nasdaq Quotation Service to Provide Quotes

The Nasdaq OMX Group Inc. recently announced that it will be launching a program pursuant to which it will disseminate pricing information on structured products using its Mutual Fund Quotation Service. There will be an initial fee for inclusion of a tranche of notes on the service.

Issuers and their affiliated broker-dealers may want to consider the advantages and disadvantages associated with this service. Given that regulators and the popular press regularly note that there is a lack of transparency in the market for structured products, the dissemination of pricing information may be helpful. This information may be helpful for distributors who sell notes offered by various issuers, as it will provide ready access to comparative pricing information. Funds and insurance company buyers may find it beneficial to have pricing information to permit them to mark their positions. Having such information regularly disseminated also may help in establishing that there is a two-way market for these securities for purposes of other regulatory requirements, such as Volcker Rule requirements. However, it also raises concerns if the pricing information is inconsistent with the estimated values ascribed to the securities at the time of offer, and if subsequent to that, the pricing information fails to reflect accurately the value of the securities. Moreover, pricing information may lead to confusion among investors, who generally should view products as buy-and-hold investments, if they are led to believe that these are securities with a liquid secondary market and may erroneously trade in or out of the securities.

LinkedIn

We have created a LinkedIn group, StructuredThoughts. The group will serve as a central resource for all things Structured Thoughts. For example, we have posted on the page all back issues of Structured Thoughts. From time to time, we will be disseminating news updates through the LinkedIn group. For updates, we invite you to join the group: http://www.linkedin.com/groups/StructuredThoughts-6547296?home=&gid=6547296&trk=anet_ug_hm.

Structured Products Conference: Regulation, Legal and Compliance Issues and Bootcamp Training Sessions

On Tuesday, December 10, 2013, the *Structured Products* magazine conference will take place in Washington, D.C. Key regulators from the SEC and FINRA, together with leading industry participants, will discuss important issues facing the industry. After these presentations, Morrison & Foerster attorneys will deliver a series of five bootcamp classes on a range of legal and compliance issues relating to structured products.

The conference will be held at the Washington Marriott at Metro Center, 775 12th Street N.W. To obtain the conference schedule, and to register, click here: http://www.structuredproductswashington.com/static/agenda

Bootcamp topics include:

- Bootcamp 1: New product approval: We will discuss FINRA’s guidance; what it means for market participants; industry standards for new product approval processes and procedures; and how FINRA’s guidance relating to investor suitability comes into play.

- Bootcamp 2: Dealing with distributors: We will discuss know-your-distributor policies and practices, training for distributors, allocation of responsibilities as between product manufacturers and distributors, and structuring dealer relationships.

- Bootcamp 3: Compliance concerns: The compliance Kitchen-Sink presentation: We’ll address everything from training policies for structured products marketers, to policies relating to monitoring product concentration in customer accounts, secondary market repurchases and trading in and out of products.

- Bootcamp 4: Disclosure issues: We’ll discuss estimated value disclosure; issues in deriving those numbers; variable price reoffering disclosure practice; and some of the unique disclosure issues raised by the use of novel or proprietary indices.

- Bootcamp 5: Taxation of financial products: This session will provide an update on recent federal income tax developments involving financial products including a discussion of the mark-to-market proposal for financial derivatives that is being floated in Congress as part of fundamental tax reform and an update on FATCA.

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For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/Thinkingcapmkts.

Morrison & Foerster named Structured Products Firm of the Year, Americas, 2012 by *Structured Products* magazine for the fifth time in the last eight years. See the write up at http://www.mofo.com/files/Uploads/Images/120530-Americas-Awards.pdf.

Morrison & Foerster named Best Law Firm in the Americas, 2012, 2013 by *StructuredRetailProducts.com*.

Morrison & Foerster named Legal Leader, 2013 by *mtn-i* at their Americas Awards. Two of our 2012 transactions were also granted awards of their own as a result of their innovation.

Morrison & Foerster named European Law Firm of the Year, 2013 by *Derivatives Week* at their Global Derivatives Awards.

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life sciences companies. We've been included on *The American Lawyer*'s A-List for 10 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.