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Structured Thoughts

News for the financial services community.

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Reverse Inquiry Transactions in the Spotlight

"Reverse inquiry transactions" take a variety of forms. In the classic example of a reverse inquiry, a particular investor or its representative reaches out to a structured note manufacturer to request a note of a particular type, underlying asset, and other pricing terms.

In addition, a variety of transaction types, and types of relationships among the parties, fall within this rubric. A prior course of dealing may exist between the investor, on the one hand, and the product manufacturer on the other hand. The parties may engage in ongoing discussions as to a particular transaction type. In addition, an investor may reach out to a variety of manufacturers about the same investment idea, and select the one that reverts with the most favorable pricing terms.

A reverse inquiry transaction can often be effected on a private placement basis, due to the limited number of investors, and (in general) their relative sophistication. And in fact, some institutional investors prefer Rule 144A transactions, in order to maintain the confidentiality of their investment idea as to a particular underlying asset, especially if that underlying asset consists of an individual equity security. However, many (or most) reverse transactions that occur today are effected on a registered basis, since that is often the most convenient "wrapper" for the parties to use for the product. And the registered basis for the offering is one of the key factors (but not the only factor!) that makes these offerings subject to regulation by the SEC and FINRA.

In recent months, a variety of issuers and broker-dealers have received questions from these regulators about these transactions. The aim of these inquiries has been obscure to some extent, and many market participants have been curious about the nature of the review – the investors who make reverse inquiries are often the investors who are most expert in the relevant products, and they are often in a position to negotiate the best economic terms with product manufacturers. As a result, these transactions might at first glance appear to be the ones that would be of reduced interest to securities regulators.

Of course, a variety of "garden variety" securities law and related concerns may be relevant to many reverse inquiry transactions:

- Is the broker-dealer applying its proper approval and other procedures before effecting a reverse inquiry transaction? For example, is it considering whether a security issued in a reverse inquiry transaction should be treated as a "new product", subject to its standard new product approval procedures?

- Has the broker-dealer properly discharged its duty to make a suitability determination for that investor? (Under FINRA's guidance, an "institutional account" may be deemed to be able to look out for itself. (FINRA Rule 2111(b).)

- Does the broker-dealer have a contrary research recommendation relating to the stock or other asset that is the subject of the reverse inquiry transaction? Is the investment thesis of the reverse inquiry transaction inconsistent with the firm's overall recommendations? If either is the case, has the broker-dealer disclosed this to the investor?

- Is the investor making its investment decision based on the improper use of material non-public information about the underlying asset? If so, does any representative of the product manufacturer have any responsibility for that improper use?

- How do the pricing and economic terms afforded in the reverse inquiry transaction compare to the pricing and economic terms in broader offerings? Are there any superior economic terms that call into question the appropriateness of the terms of similar offerings made to retail investors? How do the profits of the broker-dealer compare in each case, and are they disclosed in each case in an appropriate manner?

- Has appropriate conveyance of information about the issuer and the offering been made available to the investor in the reverse inquiry transaction prior the investor's investment decision?

In addition to these issues, it is possible that in some reverse inquiry transactions, a "stub" piece of a reverse inquiry transaction could be sold to investors other than the investor that initially made the reverse inquiry. This could occur, for example, if a structured note was designed around a "lead order" made on a reverse inquiry basis, and the product manufacturer sought to sell the offering to additional investors. In such a case, a variety of additional concerns may arise. For example, does the reverse inquiry transaction consist of a product that is too complex for certain other investors who might purchase it? In addition, the investment goal of the lead investor (for example, to hedge a different position) may be inconsistent with the investment needs of the additional investors added to the offering.

The ongoing investigation of reverse inquiry transactions is yet another factor in today's environment that should encourage market participants to carefully consider how they offer and price these transactions. During 2013, we may see from the SEC and FINRA the results of their review, and whether they have identified practices that they deem to be inappropriate.

How Will the Fed's Proposed Foreign Bank Rules Affect Foreign Bank Debt Financing Activities in the U.S.?

Last December, the Federal Reserve Board proposed regulations to implement the enhanced prudential regulation and early remediation requirements of Sections 165 and 166 of the Dodd-Frank Act. These proposals, if adopted, would apply to systemically-important foreign banks with U.S. banking operations, and to foreign nonbank financial institutions that are designated by U.S. authorities as systemically significant. The proposed rules, which are very similar to rules proposed in December 2011 for large U.S. banks, cover a broad range of regulatory subjects, including capital, liquidity, stress testing, risk management, single counterparty credit limits, conditional debt-to-equity ratios, and early remediation. In addition, the proposed rules would require a covered foreign banking organization with $10 billion or more of U.S. assets (excluding its U.S. branch and agency assets) to place all such assets and related activities under an intermediate U.S. holding company that would be separately subject to U.S. regulatory capital and other requirements, substantially as if it were a U.S. bank holding company.

While the specific requirements of the proposed rules may be changed during the process of adopting them in final form—which may occur sometime in 2013—the broad thrust of these proposals is not likely to change materially when they are finally adopted, for at least two reasons. First, these foreign banking organization rules, with the exception of the intermediate holding company requirement, are required under the Dodd-Frank Act, so the Federal Reserve Board is obligated by statute to put into place a regulatory scheme of this nature for large foreign banks with U.S. banking operations. Second, the Federal Reserve Board has signaled its concerns over the nature, size and tenor of foreign banking organizations' U.S. operations, especially their capital markets and corporate finance operations, and the ramifications of such activities for U.S. financial stability. In short, the Federal Reserve Board has effectively committed itself to the regulatory course of action reflected in its proposed rules.

The rule proposals have generated extensive discussion about their impact on foreign banking organizations doing business in the U.S., and how those foreign banking organizations may respond to these rules in conducting or modifying their U.S. activities. Although the focus of these discussions has generally revolved around the substantive U.S. business activities and operations of foreign banking organizations, foreign bank issuers that obtain funding for their operations in the U.S. through debt issuances should pause and reflect on the possible effects of these rules on their U.S. financing activities.

Fortunately, for many foreign banking organizations, the news on this front should be relatively good. First, foreign banks that do not have any U.S. banking operations other than representative offices, and that issue debt in the U.S. markets, will not be affected in any respect by the new rules when they are adopted. Second, foreign banking organizations that access the U.S. debt markets directly from their home offices (e.g., through registered or Rule 144A offerings) also will not feel the impact of the Federal Reserve Board's foreign bank rules.

Two other types of foreign banking organization debt issuances, however, may be affected: (i) debt issuances where a U.S. branch or agency issues or guarantees a debt security issued in the U.S. markets in reliance on the Securities Act section 3(a)(2) exemption for securities issued or guaranteed by a bank, and (ii) debt issuances by the U.S. holding companies of foreign banking organizations.

In the case of section 3(a)(2) offerings, the Federal Reserve Board's rules may have an incrementally greater impact, but even that impact should not be significant in most cases. U.S. branches and agencies are not subject to the rules' separate U.S. regulatory capital requirements, and the impact of the risk-management, stress-testing, single counterparty credit limits and early remediation requirements on U.S. branch and agency financing activities will either be indirect or incidental. The proposed liquidity requirements that would apply to U.S. branches and agencies of foreign banking organizations with $50 billion or more of combined U.S. assets (namely, 14 days of liquidity in the form of cash and high-quality assets), might have an impact on the use of debt issuance proceeds by affected foreign banking organizations. Also, the conditional debt-to-equity limits for foreign banking organizations that are identified as posing a "grave threat" to U.S. financial stability, and the asset maintenance requirements (calculated as a percentage of assets to covered liabilities) for designated foreign banking organizations, and foreign banking organizations that are not in compliance with the rules' stress-testing requirements (or are in Level 3 remediation), would be a potentially significant complication for troubled or noncompliant foreign banking organizations with U.S. branch/agency debt outstanding. That complication, however, would not be present in the ordinary course of the U.S. branch's or agency's funding activities, although it would have to be factored into the risk management and stress-testing activities required under the rules, and would complicate asset-liability management activities if the foreign banking organization were to be designated or remediated, or fall out of stress testing compliance.

The impact of the rules on U.S. financing activities conducted through domestic intermediate holding companies presents more interesting questions, assuming foreign banking organizations elect to pursue this route for their funding activities. Foreign banking organizations that seek debt funding through their intermediate holding companies would need to consider the impact of the Federal Reserve Board's separate regulatory capital and liquidity requirements on the direct and indirect costs of such funding. The cost-benefit analysis of this funding strategy, however, may be influenced by the fact that the Federal Reserve Board at some point is likely to require U.S. bank holding companies—and possibly the top U.S. intermediate holding companies of foreign banking organizations—to hold minimum amounts of long-term debt that would be available to absorb losses in the event of a resolution. Moreover, the issuance of intermediate holding company debt would have to become part of the intermediate holding company's broader risk management, stress testing and capital planning activities that would be required under the Federal Reserve Board's rules.

In sum, the impact of the Federal Reserve Board's rules on the U.S. operations of foreign banking organizations will be of greater or lesser significance depending on the size and tenor of a foreign banking organization's U.S. activities. The rules' impact on their U.S. debt financings, however, currently is not expected to be material in most cases.

IOSCO Commences Consultation on Benchmarks

A task force of the International Organization of Securities Commissions ("IOSCO") has announced a consultation on financial benchmarks. The consultation demonstrates the heightened regulatory interest in the uses and reliability of market measures. In addition, the consultation and its results will also likely be considered by many market participants in connection with the construction of a variety of both proprietary and non-proprietary indices. IOSCO's materials relating to the consultation may be found at the following link: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD399.pdf.

To some extent, the consultation focuses on interest rates and exchange-traded products as examples of benchmarks that are subject to its review. However, the scope of the review extends to indices and other common market measures.

In the consultation, IOSCO requested responses to concerns regarding the potential inaccuracy and manipulation of different investment benchmarks. The consultation identifies a broad range of questions and policy issues.[1]

Among the issues addressed by the consultation are:

- the methodology of benchmarks, and whether they are appropriate as to the asset or assets that they are measuring;
- the transparency of benchmarks;
- the potential for manipulation of benchmarks, or errors in their calculation;
- the extent of a sponsor's discretion in calculating the benchmark, or making adjustments based on unforeseen circumstances;
- the process by which benchmark changes are made and publicized;
- oversight of a benchmark, and whether an independent third party is used to address questions and conflicts; and
- the degree of regulatory oversight (including possible self-regulation) that may be appropriate for different benchmarks.

According to the consultation, IOSCO's task force considers benchmarks as needing to have the following characteristics in order to be credible:

- Representative: a Benchmark should clearly convey the economic realities of the underlying interest it seeks to measure to its users;

[1] The new consultation follows on from the UK's Financial Services Authority issuing its own consultation in December 2012 as to financial benchmarks. (Available at: http://www.fsa.gov.uk/static/pubs/cp/cp12-36.pdf.)

- Reliable: the data relied upon to construct the Benchmark should be sufficient to represent that interest and the data should be bona fide;

- Transparent: there should be sufficient transparency over the Methodology, calculation and inputs to allow users to understand how the Benchmark is derived and its potential limitations; and

- Subject to clear governance and accountability mechanisms.

Most market participants would probably generally agree as to the validity of these criteria. However, in light of the wide variety of investment benchmarks and their various assets and markets that they measure, a one-size fits all approach would probably not be workable.

The consultation raises the topic of "independent review" of a financial benchmark. This topic is often controversial in the context of proprietary and bespoke indices. For some index manufacturers, the index may have a new and untested market, or may be directed at a relatively limited number of investors. Under these circumstances, the benchmark's developer may be reluctant to invest in the effort to educate a third party reviewer as to the rules and nature of the index, or to commit to the ongoing expense of retaining these types of services. Accordingly, for many types of proprietary indices, the absence of independent review may remain an ongoing obstacle to conforming to any review practice that emerges among some types of indices. Instead of independent review, sponsors of these indices are likely to seek to adopt alternative systems of controls to ensure integrity, and to avoid the misuse of discretion.

The consultation also does not appear to differentiate between benchmarks that are designed to serve as a measurement of a market sector, such as the S&P 500 Index or a typical commodity index, on the one hand, as opposed to proprietary indices that follow a particular investment strategy that is designed to outperform the market, or to avoid correlation with other assets. These latter types of market-measures are often likely to involve different planning considerations than the former. In fact, because proprietary indices are not typically thought of as "benchmark indices" that are put to broad use, they may not be the principal focus of IOSCO's inquiry.

The task force indicated that it expects to issue final principles to reflect the findings of its review. However, it will *not* (emphasis in original) make recommendations relating to any particular benchmark.

IOSCO has requested responses to the consultation on or prior to February 11, 2013.

Extended Settlements and Regulation T

When scheduling settlements of registered securities to be paid in cash, issuers and broker-dealers should be wary of requests from investors to extend the settlement period beyond the fifth business day after the pricing date ("T+5"). Section 220.8(b)(1) of Regulation T (12 C.F.R. § 220) requires that a creditor (a broker-dealer) obtain full cash payment for nonexempted securities from the customer within five business days of the pricing date for the securities. Section 220.8(b)(2) of Regulation T provides an exemption for payment delays of up to 35 calendar days, if caused by the mechanics of the transaction and not related to the customer's willingness or ability to pay. That exemption is construed as encompassing, for example, settlement extensions caused by market mechanics or mechanics relating to the security itself, such as certain types of pass-through asset-backed securities, which have resulted in a practice of delayed delivery. Settlements exceeding T+5 and not within an exemption provided by Regulation T may constitute prohibited extensions of credit.

Remedies for violations of Regulation T are administered by the Securities and Exchange Commission and the Financial Industry Regulatory Authority, Inc., and such violations could be cited in a FINRA deficiency letter.

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

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

MoFo Teleconference: Exchange-traded Funds—Issues for 2013

This teleconference, which is scheduled for Thursday, February 21 from 11:00AM – 12:00PM, is designed as a primer regarding exchange-traded funds.

Topics include:

- The distinctions between mutual funds and ETFs;
- How ETFs are created and how they trade;
- The regulatory infrastructure governing ETFs;
- The registration and listing process;
- Recent changes regarding the use of derivatives in ETFs; and
- Information about other types of exchange-traded pools and notes.

To register, please email Rachel De Dora at rdedora@mofo.com or call (212) 336-4011.

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