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Structured Thoughts

News for the financial services community.

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The SEC's Proposed Amendments to Regulation M: Potential Impact on Structured Notes

Introduction

Section 939A of the Dodd-Frank Act requires the SEC to review (i) any regulation that requires the use of an assessment of the creditworthiness of a security and (ii) any reference to or requirement in such regulations regarding credit ratings, and to modify them to remove those references and substitute standards of creditworthiness the SEC determines to be appropriate.[1] The SEC's proposed amendments to Regulation M, announced during the second quarter of 2011, would remove the references to credit ratings in Rules 101(c)(2) and 102(d)(2) of Regulation M, and replace them with new standards relating to the trading characteristics of covered securities.

In this article, we discuss the potential impact of these amendments on the structured notes market. In its proposing release,[2] the SEC stated that it intended generally to except from Regulation M the same types and amounts of securities that are currently excepted in Rules 101(c)(2) and 102(d)(2), without referencing credit ratings. However, the approach outlined in the proposed rules does not appear likely to satisfy this goal as to structured note issuances.

[1] Dodd-Frank Act, § 939A(a)(1)-(2) and (b).
[2] Available at: http://www.sec.gov/rules/proposed/2011/34-64352.pdf.

Proposed Amendments to Rules 101 and 102 of Regulation M

Regulation M prohibits activities that could artificially influence the market for a "covered security."[3] Rules 101 and 102 of Regulation M prohibit issuers, underwriters, other distribution participants, and any of their affiliated purchasers, from directly or indirectly bidding for, purchasing, or attempting to induce another person to bid for or purchase a covered security during the applicable restricted period. Rules 101(c)(2) and 102(d)(2) except from their respective provisions "investment grade nonconvertible and asset-backed securities,"[4] which are nonconvertible debt securities (as well as nonconvertible preferred securities and asset-backed securities) that are rated by at least one nationally recognized statistical rating organization in one of its generic rating categories that signifies investment grade.[5] This category, nonconvertible debt securities, has been generally deemed to include most structured notes issued by financial company issuers that have an investment grade rating for their senior debt securities, other than structured notes that are exchangeable for another type of security, such as, for example, "reverse convertible securities."

We have summarized the proposed amendments in our recent news bulletin (available at: http://www.mofo.com/files/Uploads/Images/110524-Regulation-M.pdf). However, we repeat here some of the key provisions, in order to indicate how they could apply to structured notes.

The SEC's proposed amendments would replace the references to credit ratings in Rules 101(c)(2) and 101(d)(2) with new standards relating to trading characteristics of investment grade nonconvertible debt securities. Those securities will be excepted from Rules 101 and 102 if they:

1) are liquid relative to the market for that asset class;

2) trade in relation to general market interest rates and yield spreads; and

3) are relatively fungible with securities of similar characteristics and interest rate yield spreads.

As described in more detail below, a wide variety of structured notes are not likely to fit within these standards.

Proposed New Standards

Liquid Relative to the Market for that Asset Class

To determine whether nonconvertible debt securities are liquid relative to the market for their respective asset class, the following factors could be considered:

- the size of the issuance;
- the percentage of the average daily trading volume by persons other than the persons seeking to rely on the exception;
- the number of market makers in the security being distributed other than the persons seeking to rely on the exception;
- the overall trading volume of the security;
- the number of liquidity providers who participate in the market for the security;
- the trading volume in similar securities or other securities of the same issuer;

[3] 17 C.F.R. §§ 242.101 et. seq. (March 4, 1997). The term "covered security" includes most types of securities that are subject to a distribution, unless otherwise excepted by Regulation M.
[4] Regulation M, §§ 242.101(c)(2) and 242.102(d)(2).
[5] *Id*.

- the overall liquidity of all outstanding debt issued by the same issuer; and
- how quickly an investor could be expected to sell the security after purchase.

The list of proposed factors is illustrative and the SEC does not intend it to be exhaustive or mutually exclusive. However, most structured note issuances are likely not to satisfy these standards. The small aggregate principal amount of many issuances, the limited number of marketmakers for them, and their limited liquidity are likely to be barriers for most issuances to qualify, even if they are listed on a securities exchange.

Trade in Relation to General Market Interest Rates and Yield Spreads

Nonconvertible debt securities would need to trade at prices that are primarily driven by general market interest rates and spreads applicable to a broad range of similar securities to qualify for the proposed exception. As a result, the exception is limited to securities that trade in relation to changes in broader interest rates (based on their comparable yield spreads), and securities that trade in relation to issuer-specific information or credit quality would not qualify. The SEC also noted that it would be more difficult for market participants to determine that a security trades in relation to changes in broader interest rates if it trades in an idiosyncratic fashion based primarily on its specific characteristics, such that the traded price could not readily be compared to similar issues. This standard will eliminate many types of structured notes from the exemption provided from Rule 101 and Rule 102, in light of the customized terms of most structured products.

Relatively Fungible with Securities of Similar Characteristics and Interest Rate Yield Spreads

In order for a security to be relatively fungible (in terms of trading characteristics) under the proposed amendments, a portfolio manager would be willing to purchase it in lieu of another security with similar characteristics, such as yield spreads and credit risk.[6] As to this standard, the unique characteristics and terms of different types of structured notes would seem to disqualify many or most of them from this test.

Evaluation Under the Proposed Standards

An issuer or underwriter seeking to rely on the new exception must determine that the specific nonconvertible debt security being distributed meets the proposed standards using reasonable factors. These entities would be required to exercise reasonable judgment in conducting their analysis, and the determination must be subsequently verified by an independent third party.[7] However, sole reliance on a third party's determination, without any further analysis, would not be considered to be based on reasonable judgment. Persons seeking to rely on the exception must demonstrate compliance with the requirements of the proposed amendments.

Accordingly, if adopted, these proposals will require significant changes in the operations of underwriters and other distribution participants. Such changes, including the retention of an independent third party, would likely add significant cost to each issuance, making a variety of potential offerings less attractive to the offerors, even assuming that the relevant issuances could satisfy the new standards.

Potential Impact

Assuming that a particular structured note issuance would not satisfy the new standards for exclusion from Regulation M, the marketing and trading of such issuances could change in a number of ways. These changes would arise from Rule 101's and Rule 102's prohibition of bidding for, purchasing, or attempting to induce any person to bid for or purchase, a covered security.

[6] However, the security need not be deliverable for a purchase order for a different security and it need not be completely fungible for all purposes with another security with similar characteristics in order to satisfy this standard.
[7] An affiliate of an issuer or the underwriter, or counsel to these parties, would not satisfy the independence standards.

Reopenings and Multiple Tranches. A variety of structured note issuances are (a) "reopened" with an additional principal amount of fully fungible securities after the closing date or (b) priced on multiple days prior to their initial closing. For example, in the case of (b), an issuer could agree on successive business days to offer different principal amounts of the same series of notes to different investors, and to close these offerings on the same closing date.

In these cases, the issuer and the underwriter would be barred by the proposed new rules from posting bids or quotes on the initially offered securities until the distribution of that series has been completed. Because the initial offering of the relevant notes would typically not qualify for the exemption from the definition of "covered securities," issuers and underwriters would be limited in terms of their ability to make a market.

Variable Price Reofferings. In variable price reofferings, underwriters typically offer the relevant securities for several days or several weeks, at offering prices that vary based on prevailing market prices. In this context as well, the brokers participating in the distribution would have a limited ability to make a market for the securities that investors previously agreed to purchase, until the termination of the variable price reoffer.

Length of Restricted Period. Rule 100's definition of "restricted period" would not be affected directly by the proposed amendments. However, because many structured notes would no longer be exempted from Regulation M, the parties to an offering would need to consider whether Rule 100's (a) five-business-day or (b) one-business-day restricted period would apply. As a practical matter, the five-business-day period would generally apply, so that the restricted period for most issuances would generally begin five-business-days prior to the determination of the offering price. This is because most structured notes would not qualify for the shorter restricted period of one business day — they would not satisfy Rule 100's requirement of having an average daily trading volume of at least $100,000. As a result, in the case of a reopening, a broker would generally need to cease its market-making activities at least five business days prior to the time at which it proposed to commence the offering of the issuance to be reopened.

Unsolicited Transactions. These potential restrictions would not fully eliminate the ability of a broker to agree to repurchase structured notes that were otherwise subject to Regulation M. Issuers and broker-dealers would retain the exemption for "unsolicited transactions" that are contained in existing Rule 101 and Rule 102. For example, if a customer sought to sell back to a broker a structured note that was subject to a variable price reoffer or a reopening, it could reach out to the broker to propose the repurchase.

Request for Comments

The SEC seeks public comment on the proposed rules by July 5, 2011. In addition to comments on the proposed standards, the SEC is interested in whether and in what circumstances issuers, selling security holders, distribution participants, and their affiliated purchasers rely on the current exception for investment grade securities, including with respect to specific activities, and whether it serves a continuing purpose with respect to nonconvertible debt. The SEC is also soliciting comments as to whether the current investment grade exception should be eliminated or, alternatively, whether it should be expanded to except from Rules 101 and 102 all nonconvertible debt, nonconvertible preferred, and asset-backed securities (or some subset of those types of securities). The SEC seeks comments generally on any relevant changes to the debt markets since Regulation M's adoption in 1996 and how those developments should affect the SEC's evaluation of the proposed amendments. In light of the emergence of the structured note market since that time, and the impact of the proposals on this market, we anticipate that a variety of comments will address the unintended consequences of the proposed amendments on this market.

Update on FINRA Know Your Customer and Suitability Compliance

New Effective Date: July 9, 2012

On May 18, 2011, FINRA announced in Regulatory Notice 11-25 that it is extending the implementation date for compliance with FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability). The new effective date is July 9, 2012. The notice may be found at: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123701.pdf.

This new date gives firms a nine-month extension to modify their procedures, implement policy changes, and educate associated persons to comply with the new rules. The original effective date was October 7, 2011. The provisions of FINRA Rule 2090 and Rule 2111 may be found at: Regulatory Notice 11-02, http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf.

New FINRA Guidance for Rule 2090 and Rule 2111

In addition to announcing a new effective date, Regulatory Notice 11-25 provides guidance to frequently asked questions about the new rules. However, note that existing guidance and interpretations of Rule 2090 and Rule 2111 continue to apply to the extent that they are not inconsistent with the new rules.

We previously described the provisions of FINRA Rule 2090 and Rule 2111 in Volume 1, Issue 13 of Structured Thoughts (available at: http://www.mofo.com/files/Uploads/Images/101004-Structured-Thoughts-Issue-13.pdf), as well as FINRA's announcement of the original effective date of the rules in Volume 2, Issue 1 of Structured Thoughts (available at: http://www.mofo.com/files/Uploads/Images/110120-Structured-Thoughts.pdf). However, we repeat here some of the key provisions, in order to indicate how some of the new guidance applies.

Rule 2090 (Know Your Customer)

Rule 2090 requires firms to "use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer…"[8] Essential facts are "those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."[9]

Regulatory Notice 11-25 clarifies that the obligation under subsection (c) to "understand the authority of each person acting on behalf of the customer" requires the firm to know both (a) the names of any authorized persons and (b) any limits on their authority that the customer establishes and communicates to the firm.[10]

Rule 2111 (Suitability)

Rule 2111 requires that a firm or associated person "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the

[8] FINRA Rule 2090, Regulatory Notice 11-02 (Jan. 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf.
[9] *Id*.
[10] Regulatory Notice 11-25, page 2.

information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile."[11]

This profile includes, but is not limited to, "the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information that the customer may disclose to the member or associated person in connection with such recommendation."[12]

The Customer's Investment Profile

A firm must attempt to obtain and analyze relevant customer-specific information, but may use its own appropriate method or process to obtain it. Rule 2111 does not include explicit documentation requirements. In order to fulfill the general obligation to evidence compliance with FINRA rules, the firm may document suitability depending on the complexity, strategy, performance, and/or risks involved.[13]

- If a firm has not obtained all of the customer-specific information listed in Rule 2111 (age, investments, financial situation, tax status, investment objectives, investment experience, time horizon, liquidity needs, and risk tolerance, etc.), it must carefully consider whether it has sufficient understanding of the customer to properly evaluate suitability.[14]
- If a firm allows a customer to use different investment profiles or factors for different accounts, it cannot use factors from different accounts to justify a recommendation that is not appropriate for the account for which the recommendation is made.[15]

Strategies

The term "strategy" is interpreted broadly. Rule 2111 would cover a recommended investment strategy regardless of whether the recommendation results in a securities transaction. The more complex and risky the strategy is, the more the firm using a risk-based approach should focus on the recommendation.[16]

Rule 2111 would also capture an explicit recommendation to hold a security or securities. However, a hold recommendation would not create an ongoing duty to monitor and make subsequent recommendations absent an agreement that might alter the normal broker-customer relationship.[17]

"Safe-Harbor" Provision in Supplementary Material

Rule 2111 exempts certain educational material as long as the material does not include a recommendation of a particular security or securities.[18] However, the provision is limited in scope.

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[11] FINRA Rule 2111, Regulatory Notice 11-02 (Jan. 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf.
[12] *Id*.
[13] Regulatory Notice 11-25, page 3.
[14] *Id*.
[15] Regulatory Notice 11-25, page 5. For example, a customer may utilize one account to hold fixed income securities and "principal protected" structured products, and a second account to hold securities that are more likely to result in loss of principal.
[16] Regulatory Notice 11-25, page 6.
[17] *Id*.
[18] FINRA Rule 2111, Supplementary Material .03.

FINRA recommends that firms take a conservative approach when seeking to rely on Rule 2111 for strategy-related communications that are educational in nature, because any significant variation from the list in the provision (such as general and interactive financial and investment information, descriptive information about an employer-sponsored retirement or benefit plan, asset allocation models) is subject to regulatory scrutiny. However, it is important to note that the rule does not apply if a reasonable person would not view the communication as a recommendation. This means that the suitability rule covers the firm's recommendation to a customer, but generally not a firm's marketing brochure that explains risks and benefits without suggesting that the reader customer take action.

This safe harbor is likely to be relevant to offerings of structured products. For example, issuers and underwriters often distribute free writing prospectuses that describe products or strategies to customers. Given that the safe harbor is limited, issuers and underwriters should continue to review free writing prospectuses to ensure that they are not appearing to make a recommendation.

Reasonable-Basis Obligation

The reasonable-basis obligation provision has two main components. A broker must 1) perform reasonable diligence to understand the risks and rewards associated with the strategy and 2) determine whether the recommendation is suitable for at least some investors based on that understanding.[19] A broker can violate reasonable-basis suitability if either of the two elements is missing. Therefore, even if a firm's "product committee" has approved a product for sale after performing due diligence, an individual broker's lack of understanding could still violate the reasonable-basis obligation.[20]

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For additional information, please refer to FINRA Regulatory Notice 11-25, linked above.

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[19] FINRA Rule 2111.
[20] Regulatory Notice 11-25, page 8.