Morrison & Foerster News Bulletin Volume 4, Issue 10 July 9, 2013

Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Chasing Return, Reprise

Two years ago, in the summer of 2011, FINRA released its investor alert "The Grass Isn't Always Greener—Chasing Return in a Challenging Investment Environment."[1] The alert focused on how investors, in the then-existing low interest rate environment, were purchasing structured products and other more complex investments in an effort to increase their returns.

What has changed in the past two years?

The rate environment hasn't necessarily changed much. (See graph below.) But product offerings have evolved, and some of them raise issues that make the investor alert still relevant today.

The 2011 alert was issued not long after several FINRA actions involving unsuitable sales of "reverse convertible securities." Since that time, many broker-dealers have enhanced their supervision of sales of that particular product, and the investing public has developed a greater awareness of how it works, and for whom it is designed. (And we also believe that the disclosure documents relating to these products remain robust, with prominent disclosure of the key risks.)

The 2011 alert also focused on "curve steepeners," which can be used in some markets to increase yields. However, here in the summer of 2013, the effectiveness of these products is threatened by a narrowing gap between short-term and long-term rates.[2]

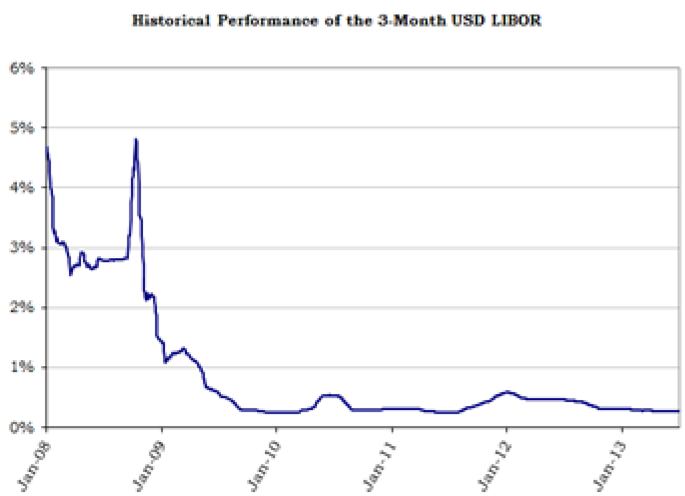
---

[1] The alert may be found at: http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/TradingSecurities/P123947. Our summary of the alert may be found at: http://www.mofo.com/files/Uploads/Images/110727-Structured-Thoughts.pdf.

[2] See, for example, "Narrowing of Swap-Rate Spread Endangers U.S. 'Steepener' Notes", available at http://www.bloomberg.com/news/2013-06-21/narrowing-of-swap-rate-spread-endangers-u-s-steepener-notes.html.

Of course, the key retail structured product types that remain from the 2011 alert are non-principal protected notes. And since 2011, product manufacturers have increasingly offered different products that are designed to enhance yield, in a manner that is consistent with an investor's market outlook and risk tolerance. Various types of conditional coupon notes, autocallable notes, and "non-principal protected" range accrual notes all can be used to enhance returns. But of course, these products may result in losses, or lower returns, under different market scenarios.

These types of products may not have generated the type of specific regulatory focus of "reverse convertible notes." (And again, we believe the terms and risk factors of this class of products are the subject of many very carefully written disclosure documents.) However, brokerages must be careful to ensure that, like any other product, they are recommended only to appropriate investors, who understand their risks. Sales pitches about their above-market coupons need to be carefully balanced with a proper explanation of the downside. Brokerages also will want to know that any distributors to whom they are sold can market them in an appropriate manner.



IOSCO: Uniform Regulation and More Transparency for ETFs

Introduction

The International Organization of Securities Commissions (IOSCO) has published a report calling for financial regulators to encourage greater transparency on the differences between exchange traded funds (ETFs) and other exchange traded products (ETPs) and more uniform regulation.

IOSCO's June 2013 report, "Principles for Regulation of Exchange Traded Funds," found that globally, ETFs amount to $1.9 trillion in assets, representing roughly 7 percent of the global mutual fund market, which, in turn, is estimated at approximately $26.8 trillion.

Global Trends

The report noted several global trends of which regulators should be mindful. Among other things, the report stated:

- The ETF industry is consolidated and dominated by a few large players;
- Investor appetite for exposure to equity indices has grown in light of the low interest rate environment;

- ETF providers in some jurisdictions have substantially enhanced their disclosures;
- Synthetic ETF providers have taken significant steps to increase transparency and minimize counterparty risk.

Overview of the Principles

The report enumerates nine principles, which fall primarily into two categories. The first section concerns ETF classification and disclosures, including principles intended to clearly differentiate ETFs from other types of investments. The second section concerns structuring issues, including management of inherent conflicts of interest and counterparty risk arising from the two main types of index replication methods: physical and synthetic.

Investors in the U.S. should not be surprised by the nature of the recommendations, which are consistent with U.S. regulation of ETFs. Similarly, it would come as no surprise if the SEC were to propose regulations or issue guidance that would enhance the existing regulatory scheme, particularly with respect to disclosures, conflicts of interest or securities lending, which have been popular areas of focus for the SEC's enforcement division.

IOSCO accompanied each principle with recommended means of implementation.

The Nine Principles

The nine IOSCO principles for ETFs are:

> Principle 1: Regulators should encourage disclosure that helps investors to clearly differentiate ETFs from other ETPs.
>
> Principle 2: Regulators should seek to ensure a clear differentiation between ETFs and other collective investment schemes (CIS), as well as appropriate disclosure for index-based and non-index-based ETFs.
>
> Principle 3: Regulators should require appropriate disclosure with respect to the manner in which an index-based ETF will track the index it references. (This approach is already typical in prospectuses for U.S. ETFs.)
>
> Principle 4: Regulators should consider imposing requirements regarding the transparency of an ETF's portfolio and/or other appropriate measures in order to provide adequate information concerning (i) any index referenced and its composition, and (ii) the operation of performance tracking.
>
> Principle 5: Regulators should encourage the disclosure of fees and expenses for investing in ETFs in a way that allows investors to make informed decisions about whether they wish to invest in an ETF and thereby accept a particular level of costs.
>
> Principle 6: Regulators should encourage disclosure requirements that would enhance the transparency of information available with respect to the material lending and borrowing of securities (*e.g.*, on related costs).
>
> Principal 7: Regulators should encourage all ETFs, in particular those that use or intend to use more complex investment strategies, to assess the accuracy and completeness of their disclosure, including whether the disclosure is presented in an understandable manner and whether it addresses the nature of risks associated with the ETF's strategies.
>
> Principle 8: Regulators should assess whether the securities laws and rules of securities exchanges within their jurisdiction appropriately address potential conflicts of interest raised by ETFs.
>
> Principle 9: Regulators should consider imposing requirements to ensure that ETFs appropriately address risks raised by counterparty exposure and collateral management.

The SEC and IOSCO

IOSCO consists of 32 securities regulators of different countries, including the Securities and Exchange Commission. The SEC served as co-chair of the working group that authored the report. In the past, the SEC has disavowed reports when it found the recommendations inconsistent with its goals. For example, in 2012, the SEC publicly stated that it disagreed with IOSCO recommendations for regulation of money market funds. It appears, however, that the SEC would be amenable to the IOSCO recommendations, which it may incorporate into future rulemaking or regulatory guidance.

FINRA Removes Proposal to Require Supervision of Non-Securities Business

For the past several years, FINRA has engaged in a process to revise and consolidate its supervision rules. In a June 2013 filing,[3] FINRA abandoned its prior proposal to require broker-dealers to supervise under proposed Rule 3110(a) its lines of business outside of the securities industry. The proposed rules, which were originally filed with the SEC in 2011, had initially included supplemental material providing that for a member's supervisory system required by proposed FINRA Rule 3110(a) to achieve compliance with FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade), it must include supervision for all of the member's business lines regardless of whether they require broker-dealer registration.

Proposed FINRA Rule 3110 is based primarily on existing requirements in NASD Rule 3010 and Incorporated NYSE Rule 342 relating to, for example, supervisory systems, written procedures, internal inspections, and review of correspondence. Proposed FINRA Rule 3110 also incorporates provisions in other NASD rules relating to supervision, such as NASD Rule 3012. Proposed FINRA Rule 3110(a) requires a member to have a supervisory system for the activities of its associated persons that is reasonably designed to achieve compliance with the applicable securities laws and regulations and FINRA and Municipal Securities Rulemaking Board rules.

According to the June 2013 filing, FINRA has decided that the best course is to eliminate the proposed supplementary material relating to other business lines from the proposed rule. Instead, FINRA will continue to apply FINRA Rule 2010's standards to non-securities activities, consistent with existing case law. Rule 2010 is FINRA's general requirement of broker-dealers: "a member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."

In the structured product market, many broker-dealers market structured CDs, which are not securities, using a manufacturing and distribution methodology that is similar to that used for structured notes, which are subject to FINRA's supervision rules. Often, the personnel and processes involved in the structured CDs overlap with the personnel and processes for structured securities. Accordingly, as a practical matter, while the proposed FINRA rules would not require a supervision system for the structured CD line of business, most broker-dealers manage and monitor that business in a manner that is consistent with their structured CDs. And in light of continuing regulatory attention from FINRA and other regulators to these products, that degree of careful supervision remains appropriate.

In Case You Missed It…

FINRA Issues Sweep Letter Regarding the Use of Social Media

FINRA has followed up on its recent communications rules that reference electronic communications, and its recent regulatory notices providing guidance to the securities industry on social media. FINRA is now conducting a sweep of

[3] The proposal may be found at: http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p286229.pdf.

broker-dealers to determine their compliance with its communications rules. FINRA has posted on its website a targeted examination letter that seeks, among other things:

- an explanation of how the firm is using social media at the corporate level in the conduct of its business;
- an explanation of how the firm's brokers generally use social media in conducting the firm's business;
- the firm's written supervisory procedures concerning production, approval and distribution of social media communications; and
- an explanation of how the firm monitors compliance with its social media policies.

For additional information, please see our client alert: http://www.mofo.com/files/Uploads/Images/130619-FINRA.pdf.

UK Private Placement Regime and Non-EU Fund Managers

On June 28, 2013, the UK's Financial Conduct Authority (the FCA) published its Policy Statement on the Implementation of the Alternative Investment Fund Managers Directive in the UK. This Policy Statement sets forth the FCA's final rules for implementing the EU's Alternative Investment Fund Managers Directive (the AIFMD) (which must be adopted by July 22, 2013), as well as responding to the feedback it received from its earlier consultation papers. The UK's HM Treasury has recently clarified how AIFMD will affect alternative investment fund managers, including those based outside the EU, with respect to UK private placements and UK marketing activities.

For additional information, please see our client alert: http://www.mofo.com/files/Uploads/Images/130702-UK-IAFMD.pdf.

Basel Committee Proposes Leverage Capital Framework for Banking Organizations

On June 26, 2013, the Basel Committee on Banking Supervision published a Consultative Document that proposed specific leverage capital requirements, and related disclosure requirements. The proposal would more fully implement the leverage capital provision of the 2010-2011 revised regulatory capital accord ("Basel III"), which was adopted in the wake of the financial crisis. The proposal specifies the elements of the "Exposure Measure" for calculating leverage capital requirements, including detailed provisions relating to derivatives exposures, and credit derivatives in particular.

For additional information, including our observations as to the proposals, please see our client alert: http://www.mofo.com/files/Uploads/Images/130701-Basel-Capital-Framework.pdf.

Contacts

Jay G. Baris
New York
(212) 468-8053
jbaris@mofo.com

Bradley Berman
New York
(212) 336-4177
bberman@mofo.com

Lloyd S. Harmetz
New York
(212) 468-8061
lharmetz@mofo.com

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 its Americas Awards. Two of our 2012 transactions were also granted awards of their own as a result of their innovation.

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.