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Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Indices……………………….……...…..page 1

Proposed Extension of Rule 206(3)-3T…………………………….page 2

MNPI and Structured Products…....page 2

Investments by Federal and State Savings Associations……………..……..…....page 3

Indices

Recently, the Global Financial Markets Association (GFMA) published a statement of Principles for Financial Benchmarks, which are intended to represent best practices for financial benchmarks. The principles have as their objective promoting uniform, transparent and sound practices in relation to indices.

The GFMA defines a financial benchmark "as a commercial or published price assessment, distributed regularly to third parties and primarily intended for use as a reference in determining the pricing of, or the amount payable pursuant to, a financial instrument or contract." The Principles acknowledge that financial benchmarks vary and may be used for various purposes and the Principles are not intended to apply to: indices that are primarily used for purposes other than pricing financial contracts; customized indices used for pricing bespoke bilateral or similar transactions among a limited number of counterparties; and indices issued by public sector entities. Based on these definitions, certain indices that are used as reference assets for structured products or that are used in connection with ETFs may be included within the scope of the Principles, although it is not clear whether these types of products were contemplated in connection with the Principles.

The European Commission has published a Consultation Document on the Regulation of Indices seeking comment by November 15, 2012 on an appropriate framework. The Commission defines benchmarks as "(a) indices or published figures calculated through the application of a formula to underlying data that are (b) used as a benchmark or reference price for financial instruments." The Consultation notes that an index may involve some measure of discretion and there may be a need for a framework to ensure the appropriate exercise of discretion and to mitigate potential conflicts of interest. Market participants are urged to consider the main indices that they use, the construction of these indices, whether these indices use actual data, the extent to which discretion is employed, and whether actual transaction data is used and is readily available. The consultation sets forth a framework to address many of these issues.

The Consultation also discusses the role of a calculation agent, and outlines elements of a framework that may help address the discretion that may be exercised by a calculation agent.

The Principles, Consultation and other ongoing dialogues relating to benchmark indices are likely to raise other issues for market participants to consider and address through changes to, among other things, their compliance policies and procedures and their index arrangements.

Proposed Extension of Rule 206(3)-3T

The Securities and Exchange Commission has proposed to extend by two years Rule 206(3)-3T. The temporary rule establishes an alternative means for registered investment advisers that are also registered as broker-dealers to meet the requirements of section 206(3) of the Investment Advisers Act of 1940 (the "Advisers Act") when they act in a principal capacity in transactions with certain of their advisory clients. Absent SEC action, Rule 206(3)-3T will sunset on December 31, 2012.

The SEC adopted the Rule 206(3)-3T as a temporary rule in September 2007, as we have previously reported in prior issues of Structured Thoughts. Section 206(3) of the Advisers Act prohibits registered investment advisers from engaging in principal transactions with their clients unless they obtain written consents for each transaction. Without an alternative means of compliance with this restriction, many advisers refrained from engaging in principal trades with their clients, including those in fee-based advisory accounts (which, in light of the FPA decision, were now subject to the Advisers Act). Rule 206(3)-3T provides an alternative means for investment advisers to comply with the limitations of Section 206(3). Among other things, the adviser must make certain disclosures to clients about conflicts of interest, and obtain written, revocable consents that prospectively authorize principal transactions. Many structured products market participants rely on Rule 206(3)-3T in connection with sales of structured products issued by affiliated issuers or underwritten by the issuer's affiliated broker-dealers to advisory accounts.

The SEC proposed the amendments to Rule 206(3)-3T on October 9, 2012. The comment period ends 30 days after the publication of the notice in the Federal Register.

MNPI and Structured Products

On September 27, 2012, the staff of the Office of Compliance Inspections and Examinations (the "Staff") of the Securities and Exchange Commission issued a report titled "Staff Summary Report on Examinations of Information Barriers: Broker-Dealer Practices under Section 15(g) of the Securities Exchange Act of 1934" (the "Report").[1] The Report is intended to help broker-dealers safeguard material non-public information ("MNPI") from misuse, including insider trading, and to manage the inherent conflict of interest that arises from a broker-dealer's obligation to its client to safeguard MNPI provided for business purposes and the potential misuse of that MNPI for other purposes.

Section 15(g) of the Securities Exchange Act of 1934 requires that registered broker-dealers establish, maintain and enforce written policies and procedures, reasonably designed, taking into consideration the nature of their business, to prevent the misuse of MNPI.

Information that is deemed to be MNPI is typically placed on a broker-dealer's monitoring list to check for possible improper trading. In reviewing the controls reasonably designed to prevent the potential misuse of MNPI, the staff analyzed the types of surveillance triggered by the placement of a matter on a broker-dealer's monitoring list and whether the scope of the surveillance was sufficient to capture trading in all products that could benefit from the misuse of MNPI.

Broker-dealers conduct surveillance on products that could be used to profit from MNPI relating to particular companies, such as related derivatives and interests in such companies held through loans or as components of unit investment trusts

[1] The Report can be found at http://sec.gov/about/offices/ocie/informationbarriers.pdf. The SEC's news release summarizing the Report can be found at http://sec.gov/news/press/2012/2012-200.htm. Our client alert on the Report can be found at http://www.mofo.com/files/Uploads/Images/121001-OCIE-Report.pdf

or exchange traded funds. The Staff cited one example of a security that did not seem to be within the scope of surveillance – structured products issued by the broker-dealer or an affiliated entity. If the broker-dealer is in possession of MNPI with respect to a security underlying a structured product, the broker-dealer may need to have controls in place to prevent the issuance of that structured product from being based on MNPI. The lack of surveillance of such structured products, however, was not cited in the Staff's "Potential Concerns" included in Annex B to the Report.

Broker-dealers should have existing procedures to protect against misuse of MNPI in connection with the issuance of structured products by the broker-dealer or an affiliate. These "window cleaning" procedures are also designed to prevent, for example, violations of Regulation M in connection with hedging activities by the broker-dealer or an affiliate, issuances during the blackout period prior to the release of the broker-dealer's or affiliate's financial results, unauthorized use of marketing materials or an unauthorized release of research prior to the issuance of a structured product. Window cleaning procedures should be checked to ensure that they prevent the unauthorized use of MNPI relating to a security underlying a structured product and should generally be tested to ensure that the procedures are being followed and produce the intended results.

Investments by Federal and State Savings Associations

On July 24, 2012, the Federal Deposit Insurance Corporation (the "FDIC") issued a final rule prohibiting any insured savings association from acquiring or retaining a corporate debt security unless it determines, prior to acquiring such security and periodically thereafter, that the issuer of that security has adequate capacity to meet all financial commitments under the security for the projected life of the security.[2] The final rule, which amends 12 CFR § 362.11(b)(1), was promulgated under Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA"). The final rule replaces the investment grade standard that was removed from Section 28(d) of the Federal Deposit Insurance Act by DFA Section 939A with alternative standards of creditworthiness.[3] The FDIC also published final guidance on due diligence requirements for savings associations in determining whether a corporate debt security is eligible for investment.[4] Under the final guidance, a federal or state savings association would satisfy the requirements of 12 CFR Part 362.11(b)(1) if, based on its assessment, the issuer of the corporate debt security presents a "low risk of default" and is likely to make a "full and timely repayment" of principal and interest; these key concepts, however, are not further defined in the final guidance. The investment must also be consistent with safe and sound banking practices.

The final guidance includes examples of appropriate factors that a savings association should consider in its due diligence analysis, which include, but are not limited to, the following:

- Confirm spread to U.S. Treasuries is consistent with bonds of similar credit quality;
- Confirm risk of default is low and consistent with bonds of similar credit quality;
- Confirm capacity to pay through internal credit analysis that can be supplemented with other third-party analytics;
- Understand applicable market demographics/economics; and
- Understand current levels and trends in operating margins, operating efficiency, profitability, return on assets and return on equity.

The range and type of specific factors an institution should consider will vary depending on the particular type and nature of the security.

Although savings associations are permitted to consider an external credit rating for purposes of determining whether the investment in the corporate debt security is in compliance with the rule, they must supplement any external credit assessment with due diligence processes and analyses that are appropriate for the size and complexity of the security. A security with an investment grade rating is not automatically deemed to satisfy the rule's creditworthiness standard. The FDIC specifically stated that the more complex a security's structure, the greater the expectations, even when the credit

[2] See FDIC Financial Institution Letter FIL-34-2012 (July 24, 2012), which can be found at http://www.fdic.gov/news/news/financial/2012/fil12034.html.
[3] The final rule was published at 77 FR 43151 (July 24, 2012).
[4] The final guidance was published at 77 FR 43155 (July 24, 2012).

quality is perceived to be very high. The FDIC also noted that savings associations should not purchase securities for which they do not understand the relevant risks.

The final rule is not expected to change the scope of permissible corporate debt securities investments. If a corporate bond was a permissible investment prior to the final rule due to its falling within one of the four highest credit rating categories, a bond with similar default probabilities should be permissible under the final rule.

Because savings associations purchase structured products issued by other issuers, they will have to consider the final rule and the final guidance prior to purchasing such securities. In particular, they will have to weigh the suggested diligence factors, and any other relevant factors, such as the complexity of the structured product, prior to their investment. It also will be important for the savings associations to document their diligence activities and conclusions, inasmuch as federal examiners will want to see concrete evidence of a savings association's compliance with the new rule.

The final rule was effective on July 21, 2012. Savings associations must be in compliance with the final rule by January 1, 2013.

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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*.

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