Structured Thoughts

News for the financial services community.

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U.S. Treasury Seeks Comment on Issuances of Floating Rate Notes

In March 2012, the U.S. Treasury Department requested the public's views on whether to begin to issue floating rate notes.[1] If the Treasury elects to do so, floating rate notes would join the Treasury's fixed rate offerings and inflation-linked offerings as potential instruments that could be purchased by U.S. retail and institutional investors.

Prior to making a decision as to such issuances, the Treasury is soliciting input from a variety of market participants regarding demand for securities of this kind and their liquidity, as well as structural and operational issues that the Treasury should consider.

The Treasury set forth a number of questions as to which it seeks responses:

1. Would floating rate notes attract new investors into the Treasury market for a sustained period of time?

2. Would such notes help meet the investment needs of retail and institutional investors?

[1] The Treasury's request for comments may be found at the following webpage: https://www.federalregister.gov/articles/2012/03/19/2012-6662/public-input-on-the-development-and-potential-issuance-of-treasury-floating-rate-notes.

3. How liquid would such notes be in the secondary markets?

4. What is the ideal structure for such a note?

- What is the ideal term of such a note?
- What reference rates should be considered for these notes?
- How frequently should they pay interest?

5. What changes to trading, settlement and accounting systems would be needed to accommodate floating rate notes?

6. Are there any other operational issues that the Treasury should be aware of in deciding whether to issue these notes?

7. Given these considerations, are these notes a useful debt management tool that Treasury should consider?

The comment period for the proposal will end on April 18, 2012.

Impact of the JOBS Act on Private Structured Product Programs

In April 2012, President Obama signed the "Jumpstart Our Business Startups Act" (the "JOBS Act"). The JOBS Act is principally focused on liberalizing the U.S. securities laws to some extent to facilitate the capital raising efforts of "emerging growth companies."[2] However, a variety of the statutory provisions and SEC regulations that are amended by the JOBS Act are also relied upon by larger companies, including established financial institutions.

One example is in connection with the JOBS Act's revisions of Regulation D and Rule 144A. Section 201 of the JOBS Act requires the SEC to revise Regulation D and Rule 144A to permit general solicitation and general advertising of these offerings, provided that actual sales are only made to "accredited investors" and "qualified institutional buyers" (as applicable). These revisions are designed to address the common criticism that the existing SEC rules are too prohibitive, in that they limit communications due to the possibility that they may reach investors who cannot ultimately make purchases, and who therefore cannot be injured by the communication or by the offering itself. Section 201 of the JOBS Act is designed to focus the SEC rules on the actual sales, and ensure that they are limited to the relevant types of investors, as opposed to regulating the recipients of the offering communication.

Of course, Regulation D and Rule 144A aren't just used by emerging growth companies – these exemptions are also used by financial institutions in connection with a variety of their offering platforms. For issuers who offer structured products under Regulation D or Rule 144A, the new rules will create the possibility of utilizing a broader range of communications in the offering process. A variety of new types of advertisements, websites and web pages will become permitted, provided that the relevant issuers or their agents properly limit the actual sales to the

[2] For additional information about the JOBS Act, please see our website, www.mofo.com/jumpstart.

relevant investor type.[3] In contrast, until the new rules become effective, SEC no-action letters and market practice limit web-based offerings of Rule 144A securities to password-protected websites.

The securities offering provisions of the Office of the Comptroller of the Currency (the "OCC"), which regulate offerings of U.S. national banks and federal branches of non-U.S. banks, incorporate Regulation D and Rule 144A by reference. Accordingly, these banks will also probably benefit from the new provisions, once they are incorporated into the relevant SEC rules. As a result, bank note programs that rely on Regulation D and Rule 144A in order to obtain an exemption from OCC registration will also enjoy enhanced flexibility.

FINRA Revises Proposal re Communications with the Public

On March 29, 2012, the SEC approved FINRA's amended proposed rule revisions relating to broker-dealers' communications with the public. These rules relate to a number of areas, and potentially impact a wide variety of securities offerings.[4] The text of Amendment No. 3 to FINRA's proposals may be found at the following link: http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p125769.pdf. The SEC's effectiveness order may be found at the following link: http://www.sec.gov/rules/sro/finra/2012/34-66681.pdf.

The SEC has approved these rules on an accelerated basis. FINRA has stated that the implementation date of the new rules will be no later than one year after SEC approval, and it plans to publish a Regulatory Notice within 90 days of the SEC's approval.

We previously discussed the impact of the revisions on the structured product market in prior issues of Structured Thoughts:

- January 19, 2002: http://www.mofo.com/files/Uploads/Images/120119-Structured-Thoughts.pdf
- July 27, 2011: http://www.mofo.com/files/Uploads/Images/110727-Structured-Thoughts.pdf

We plan to provide an additional update when FINRA issues its Regulatory Notice as to the effectiveness of the new rules.

"SEC Speaks" Addresses Structured Products

At a recent Practising Law Institute program, SEC Speaks, representatives from the SEC addressed the agency's focus on structured products. The Office of Capital Markets Trends is reviewing exchange-traded products, including commodity exchange-traded products, as well as disclosures used in connection with offerings of structured products. In addition, the Office is coordinating with other divisions and groups at the SEC that also are reviewing structured products. In particular, the Office has identified a few areas that market participants should consider closely, including whether disclosures explain how an offered product works, how the product is valued by

[3] Issuers and underwriters will likely continue to use a variety of tools, such as investor questionnaires and "big boy letters" in order to verify and document the status of their investors.

[4] For example, the proposals impact Rule 2210 (Communications with the Public), Rule 2212 (Use of Investment Companies Rankings in Retail Communications), Rule 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings), Rule 2214 (Requirements for the Use of Investment Analysis Tools), Rule 2215 (Communications with the Public Regarding Security Futures), and Rule 2216 (Communications with the Public About Collateralized Mortgage Obligations (CMOs)). We discussed a variety of these provisions in our July 26, 2011 client alert, which is available at: http://www.mofo.com/files/Uploads/Images/110726-FINRA-Proposed-Rules-2210-2211.pdf.

the issuer, and how that value relates to the price paid by investors. The Office pointed to certain disclosures that could be improved, including those related to distribution practices, secondary market liquidity risks, and underlying index or asset information. In addition, consistent with questions that have been raised in recent years, the SEC urged issuers to consider whether the names used to market these products appropriately describe the product and are not misleading.

Institutional Suitability Certification

Beginning in July 2012, broker-dealers will be required to address changes to the suitability requirements. FINRA Rule 2111 provides an exception from the customer-specific suitability obligation for institutional accounts, as that term is defined in FINRA's rules. Rule 2111 is based on the notion that these types of accounts are capable of fending for themselves. In order to facilitate the use of this exception, SIFMA has made available a new certificate, the Institutional Suitability Certificate, that can be used by broker-dealers in connection with obtaining representations regarding an account's status as an institutional client. The SIFMA certificate is available at http://www.sifma.org/services/standard-forms-and-documentation/cross-product/#isc.

Section 3(c)(7) Exception under the 1940 Act

Market participants that use special purpose trust vehicles organized outside of the United States to issue structured products often rely on the exception from the 1940 Act provided by Section 3(c)(7) for the trust. A trust will not be considered an "investment company" to the extent that its securities are offered and sold solely to qualified purchasers. Generally, practitioners have relied on guidance in relation to book-entry settlement and clearance procedures for securities offered pursuant to Rule 144A/Regulation S solely to qualified purchasers in reliance on 3(c)(7). The most recent iteration of these procedures (the 2008 procedures) were recently revisited and new guidance has been published relating to secondary market transfers, which should be consulted in connection with these offerings.

Exchange-Traded Notes Update

In prior issues, we reported on the increasing regulatory scrutiny related to exchange-traded funds. We noted that in some jurisdictions, regulators were focused more broadly on exchange-traded products, which include ETNs. Largely, regulators had been concerned about market structure issues in relation to ETFs. Recent events relating to the trading of certain ETNs, including a Credit Suisse ETN, have prompted both FINRA and the SEC to confirm that the SRO and the Commission are reviewing the marketing and sales of ETNs.

Debt Research

Section 919A of the Dodd-Frank Act requires the Government Accountability Office ("GAO") to identify and examine potential conflicts of interest between investment banking and research analysts. Earlier this year, the GAO published its report (available at http://www.gao.gov/assets/590/587613.pdf), which examined the effectiveness of regulatory actions (the Global Settlement, FINRA Rule 2711, and NYSE Rule 472) in addressing research analyst conflicts of interest, and considered additional actions that regulators could take to address these conflicts. The GAO reviewed empirical studies, analyzed enforcement action data, and interviewed market participants. The GAO report identifies additional opportunities that exist to adopt or revise rules to enhance investor protection and streamline or harmonize oversight, and noted that there were few rules that specifically addressed debt research.

In a Regulatory Notice dated March 11, 2011, FINRA requested comments on a debt research conflicts of interest proposal. In February 2012, FINRA published Regulatory Notice 12-09 on Debt Research Reports,[5] in which it solicited comment on a revised debt research conflicts of interest proposal.

Under the proposal, a "debt security" would be defined as any security other than an "equity security," "treasury security," "municipal security," or "security-based swap" (as those terms are defined in the federal securities laws). A structured product generally would be considered a "debt security" for these purposes. Accordingly, research reports relating to the senior debt securities of structured product issuers also relate to their structured products. Debt research reports would be subject to the same exceptions currently in place for equity research reports in FINRA Rule 2711 (for example, discussions of broad-based indices, commentaries on economic, political, or market conditions, etc., would be excepted from the definition of a "debt research report").

Under the revised proposal, the majority of the existing safeguards and disclosures in FINRA Rule 2711 for equity research would apply to retail debt research.

Member firms would be required to implement policies and procedures to identify and manage conflicts of interest related to debt research. Generally, the policies and procedures required in the context of debt research are similar to those currently applicable in the context of equity research. Certain communications between debt research analysts and sales and trading personnel would be prohibited, such as communications by sales and trading personnel that attempt to influence a debt analyst's opinion or views for the purpose of benefiting the trading position of the firm, a customer or a class of customers; debt analysts identifying or recommending specific potential trading transactions to sales and trading personnel that are not contained in such debt analyst's currently published reports; and disclosing the timing of, or material investment conclusions in, a pending debt research report; or otherwise having any communication for the purpose of determining the profile of a customer to whom research should be directed. Certain communications between debt research analysts and sales and trading personnel are recognized as necessary and are permissible, including sales and trading personnel seeking information from debt analysts regarding the creditworthiness of an issuer (and other information regarding a debt issuer that is reasonably related to the price/performance of the debt security), so long as, with respect to any covered issuer, such information is consistent with the debt analyst's published research; debt analysts seeking information from sales and trading personnel regarding a particular bond instrument, current prices, spreads, liquidity and similar market information relevant to the debt analyst's valuation of a particular debt security; and sales and trading personnel providing input to research management regarding debt research coverage decisions, provided that final coverage decisions are made by research management.

Unlike in the equity market, institutional investors trading in debt securities tend to interact more freely with debt research analysts. In order to account for these differences, the FINRA proposal contemplates an "opt-out" for institutional investors with respect to debt research, which would require that the FINRA member firm obtain an acknowledgement that the debt research received by that institutional account is non-compliant with the FINRA rule. Institutional-only debt research would still be subject to a number of significant restrictions, and would be required to bear a prominent disclosure identifying the research as institutional-only.

The proposed rules also address distribution of research reports, and prohibit selectively distributing research to any class of customer or firm department. Different research can be distributed to customers with different time horizons or investment objectives; however, certain customers cannot be provided with research ahead of time or prior to

[5] See http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125615.pdf.

other categories of customers. There is a different, more permissive policy on the distribution of research produced by third parties.

Given that the debt research proposal would create important differences between the rules that govern equity research and the rules that govern debt research, it is worth a close look. Also, the proposal introduces the interesting use of an "opt-out" for institutional accounts. Over time, perhaps this same approach will filter over to equity research.

We are pleased to introduce you to several new members of our Derivatives & Structured Products group.

Larry Abrams has joined the Capital Markets Group. Mr. Abrams represents financial institutions, hedge funds, investment managers, insurers and corporate end-users on derivatives matters. He assists clients in designing, structuring, and negotiating derivative and structured finance transactions and repos and in negotiating securities lending arrangements and prime brokerage arrangements.

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Brad Berman has joined the Capital Markets Group. His work involves advising issuers and underwriters in debt and equity offerings and structured products issuances. Mr. Berman advises issuers and underwriters in connection with shelf registration statements, medium term note programs and exempt transactions.

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James Schwartz has joined the Capital Markets Group. Mr. Schwartz represents clients in a wide variety of derivatives transactions, including in the context of broader structured transactions, and advises on structured products. He negotiates ISDA and other trading agreements, including related collateral agreements, with a wide range of counterparties, including those subject to ERISA.

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