Morrison & Foerster News Bulletin
Volume 1, Issue 13 October 4, 2010

Structured Thoughts

News for the financial services community.

Suitability Update

In connection with its continuing process of reconciling regulations as part of the FINRA consolidated rulebook, FINRA had proposed changes to FINRA Rule 2090, the know your customer rule, and Rule 2111, the suitability rule. In late August 2010, the final proposed rules were published for comment and the comment period closed last month.

The final proposed rules would implement a number of changes. Suitability determinations would apply to recommended investment strategies, not only to recommendations relating to specific securities. There are three elements or components of suitability identified by the rule: reasonable basis suitability, customer specific suitability and quantitative suitability. In considering quantitative suitability, the broker-dealer should make a determination that a series of transactions, when viewed together, would be considered suitable for the client.

The list of items included as part of a retail investor's profile would be expanded as part of the amended rule. These items will include age, other investments, financial situation and needs, tax status, investment objectives, investment experience and time horizon, liquidity needs and risk tolerance. The current rule lists a much smaller number of items.

The rule clarifies the means by which the customer suitability obligation may be discharged in respect of recommendations made to institutional accounts. This duty would be discharged if the broker-dealer has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently (both in general and with respect to particular transactions and investment strategies) and the customer affirmatively indicates that it is exercising independent judgment in evaluating the recommendation. An "institutional account" would include an institutional investor with $50 million in assets under management.

We anticipate that the proposed rule will be adopted promptly. However, we also anticipate that suitability and related concepts will be revisited following the completion of the SEC's study on standards of care, which was mandated by the Dodd-Frank Act.

Ratings Update

Market participants were compelled to address the new (post Dodd-Frank Act) requirements relating to disclosures of ratings immediately after the legislation's enactment. Now that the SEC has provided guidance and that market practice has begun to develop, below are a few summary thoughts:

- SEC guidance clarified that rating agency consent is not required where reporting issuers included a discussion of ratings in their SEC filings as it pertains to their risk factors and Management's Discussion & Analysis sections addressing funding costs, liquidity issues, and the impact of ratings changes on these matters.
- An issuer may include ratings information in a free writing prospectus (this would include term sheets, product brochures or other marketing materials filed as FWPs) or in a Rule 134 compliant communication.
- Registration statements declared effective prior to July 22, 2010 are grandfathered, but issuers must take care to consider their disclosures, as the grandfathering applies only until the filing of the next post-effective registration statement (this includes the issuer's next annual report in Form 10-K, 20-F or 40-F).

Basel III

The details regarding the proposed new Basel III framework are beginning to take shape. We have prepared a number of detailed alerts regarding Basel, which may be found at http://www.mofo.com/resources/regulatory-reform/#basel. Here are the highlights:

1. Minimum common equity: this threshold will be set at 4.5% of risk-weighted assets.
2. Tier 1 capital requirement will be set at 6%.
3. Total capital requirement will be set at 8%.
4. For each category, there will be a 2.5% conservation buffer. If an institution "uses up" the conservation buffer and approaches the minimums, it will become subject to progressively more stringent constraints on dividends and executive compensation.
5. Minimums will be phased in between January 2013 and January 2015, and the conservation buffer will be phased in from January 2016 to December 2018.
6. A countercyclical buffer also could be imposed by countries in order to address economies that are building excessive risks as a result of experiencing rapid economic growth.

7. In addition to raising the capital requirements, the Basel III framework imposes more criteria in order for instruments to classify as common equity and to count as Tier 1 capital. Instruments that no longer will qualify as common equity will be excluded beginning in January 2013.

8. There will be higher capital requirements for certain trading, derivatives and securitization activities. These will be introduced at the end of 2011.

9. A liquidity coverage ratio will be introduced in 2015 and the net stable funding ratio will be applied starting in 2018.

Structured Certificates of Deposit: A Primer

In March 1987, Chase Manhattan Bank of New York introduced a new type of certificate of deposit ("CD"). Unlike the traditional CDs on the market, Chase's CD did not guarantee a fixed interest rate. Instead, an investor's return was based on the performance of the S&P 500 Index. More than 20 years later, structured certificates of deposit, or SCDs, have grown in popularity among investors who seek an investment that will generate a positive return when the value of an equity index or another underlying asset increases, while reducing the investor's risk of loss of principal. This article is intended as a general overview of SCDs, including a discussion of their advantages and disadvantages, the legal treatment of SCDs, and the documentation of SCD programs.

What Are Structured Certificates of Deposit?

SCDs are investments representing a bank deposit of a specified amount of money for a fixed period of time, which have periodic interest payments and/or a return at maturity that is linked to an underlying asset. Like traditional CDs, SCDs entitle the holder to his or her principal investment, plus one or more additional payments. However, unlike traditional CDs, which usually pay interest periodically, SCDs generally pay an additional payment at maturity based on the underlying market measure. The most common form of SCDs are insured by the Federal Deposit Insurance Corporation (the "FDIC"); however, some banks offer SCDs that are not so insured. The hypothetical scenario below illustrates how a basic SCD works:

Bank X issues a certificate of deposit with a two-year term and a minimum investment of $1,000. In lieu of a fixed interest rate, Bank X has offered to pay an amount equal to the appreciation of the Dow Jones Industrial Average Index (the "DJIA") over that two-year term. If the DJIA increases by 20% in the two-year time period, Bank X will pay an additional $200 for each $1,000 invested, or $1,200 in total. However, if the DJIA declines, Bank X will only pay out at maturity the principal amount.

What sets an SCD apart from a traditional CD is its customizable features, limited only to the issuing bank's imagination (and applicable laws). This allows investors access to a number of investment strategies, as well as the opportunity to gain upside exposure to a variety of market measures, while the FDIC insurance limits investor risk. While traditional CDs contemplate a specific fixed or floating rate of income, the income received from SCDs is mainly derived from the performance of the underlying reference asset, such as an equity index (e.g., the DJIA), one or more foreign currency exchange rates (e.g., the BRIC Currency Basket), commodities (e.g., oil and gas prices), or some combination of these.

In addition, SCDs may or may not be interest bearing, and may offer a variety of payment calculations. For example, payments may be calculated using the percentage increase of the market measures based on the starting level (determined on the pricing date) and the ending level (determined before the date of maturity), or payments may be calculated using the average value of the market measure on a series of observation dates throughout the term of the SCDs. In addition, the payments may be subject to a cap, or ceiling, representing a maximum appreciation in the level of the market measure. Depending on the terms, a particular series of SCDs may also have a participation rate, which represents the leverage or exposure of the SCDs to movements in the underlying market measure. For example, an investor in an SCD with a 90% participation rate will only enjoy 90% of the gains in the performance of the underlying market measure.

In short, SCDs can be designed using many of the same features as “structured notes,” with one exception: at minimum, the holder of an SCD usually receives an amount equal to the principal. This feature arises largely from the fact that the FDIC takes the position that, in order to be insurable as a “deposit,” the holder of the instrument must be entitled to at least the return of the principal amount.[1]

The Good News for Investors

SCDs can be a relatively low-risk alternative compared to other structured investment vehicles. SCDs typically provide “principal protection.” Regardless of how poorly the underlying market measure performs, at maturity, a holder will still receive the original investment amount. However, this protection is only available if the investment is held to maturity.

As an added layer of protection, the deposit amounts of SCDs are FDIC-insured. In the past, this meant that the FDIC insurance covered up to $100,000 of an investor’s deposit. However, in 2008, the federal government temporarily raised the insurance amount to $250,000 and on July 21, 2010, this temporary increase was made permanent following the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2]

It is important to note that the FDIC insurance is limited to the principal invested and any guaranteed interest rate, but not the “contingent” interest.[3] For example, in the hypothetical scenario outlined above, if the issuing bank failed prior to the maturity date of the SCD, the FDIC takes the position that the FDIC insurance would cover the $1,000 investment, but not the $200 of earnings based on the performance of the DJIA. Further, investors are still subject to the direct credit risk of the issuing bank for any dollar amount over the maximum applicable deposit insurance coverage—for example, if the investor holds other deposits with the applicable bank that together exceed $250,000.

Another notable aspect of many SCDs is the “estate feature” (otherwise commonly known as a “death put” or “survivor’s option”). To the extent provided in the terms of the particular SCD, if at any time the depositor of an SCD passes away (or in some cases, becomes legally incapacitated), the holder’s estate or legal representative has the right, but not the obligation, to redeem the SCD for the full deposit amount before the maturity date, without being subject to any penalty provisions. The estate or representative also may choose not to exercise the estate feature and instead hold the SCD to maturity.

The Bad News for Investors

SCDs possess a number of potential risks that investors should be aware of before making an investment. As mentioned above, the principal protection feature only applies if an SCD is held to maturity. Accordingly, an investor must be prepared to commit his or her investment in an SCD for the full term of the SCD.

Depending on the terms of the SCDs, there may be no assurance of any return above the deposit amount. In the end, if the market measure performs unfavorably, even though the investor may receive a return of its principal, the investor will still experience an “opportunity cost,” as compared to investing in a traditional, interest-paying CD, or another investment. Conversely, even if the market measure performs favorably, depending on the terms of the SCD, the return on the investment may be limited by a predetermined return, a participation rate of less than 100%, or some other term specific to a particular SCD. These types of features would cause the SCD to perform less well

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[1] FDIC Advisory Opinion, FDIC-87-15, September 18, 1987, Insurance Coverage for Indexed CDs. Conversely, the FDIC has held that bank products that do not offer a principal protection feature are not deemed “deposit obligations” of the bank, and therefore are not eligible for FDIC insurance. Letter from FDIC to Kevin P. Murray, dated February 27, 2002.

[2] Press Release, Federal Deposit Insurance Corporation, Basic FDIC Insurance Coverage Permanently Increased to $250,000 Per Depositor (July 21, 2010), available at http://www.fdic.gov/news/news/press/2010/pr10161.html.

[3] Letter of August 21, 2000, to the Honorable Sharon G. Bias, Commissioner of Banking, State of West Virginia, from Joseph A. DiNuzzo, FDIC Counsel.

than the relevant underlying asset. Further, because SCDs are FDIC-insured, the premiums and assessments paid by the bank issuer to the FDIC are usually passed on to the investor in the form of a lower participation rate or a lower maximum payment, as compared to non-FDIC-insured investments. In other words, a different investment, such as a non-insured structured note with comparable terms, may offer greater upside potential.

Some SCDs may also have a "call feature." This provision allows the issuing bank, at its option, to redeem the SCDs at a specified call price on one or more call dates prior to maturity. By agreeing to a specified call price, the investor effectively forgoes any possible returns that could be realized had the SCD not been called, or had the SCD been called on a later date. In addition, if an SCD is called, the investor may not be able to reinvest the proceeds in a similar instrument, since interest rates and the level of the underlying asset may have changed since the SCD was initially purchased.

Finally, SCDs are not liquid investments. Issuing banks rarely create a secondary market for SCDs, and even if a secondary market is created, the issuing banks are under no obligation to maintain it.[4] As a result, if an investor decides to sell his or her SCD prior to maturity, the amount the investor receives could potentially be lower than the initial principal amount.

Legal Considerations

Securities Act

Are SCDs subject to the registration requirement under the federal securities laws? The short answer is: it depends, but, generally, no. Section 2(a)(1) of the Securities Act of 1933 (the “1933 Act”) includes “certificates of deposit” in the definition of the term “security.” However, under relevant federal judicial and regulatory guidance, FDIC-insured certificates of deposit are generally not considered a “security” under the federal securities laws. That being said, there are limited instances in which courts have characterized certain CDs as securities, and it is useful to examine the relevant case law.

In *Marine Bank v. Weaver*,[5] the Supreme Court set forth the analytical framework for determining whether a CD would be considered a “security” under the 1933 Act. The Court focused on the difference between bank-issued CDs and other long-term debt obligations. According to the Court, FDIC-insured CDs are afforded protection by the reserve, reporting and inspection requirements of the Federal Deposit Insurance Act. Since holders of these deposits are guaranteed payment of principal by the U.S. government, the Court opined that it was not necessary to provide the added protections to CD holders that are afforded under the federal securities laws.[6] However, as a caveat, the Court added that all CDs are not automatically exempt from federal securities laws, and that “each transaction must be analyzed and evaluated on the basis of the content of the instrument in question, the purpose intended to be served, and the factual setting as a whole.”[7]

The Court’s holding in *Marine Bank* set forth a relatively straightforward analytical framework with regard to CDs. Three years later in *Gary Plastics Packaging v. Merrill Lynch, Pierce, Fenner, & Smith Inc.*,[8] the line between a CD deemed a security and one not deemed a security became a little blurred. In *Gary Plastics*, Merrill Lynch (“ML”) marketed “bundled” insured certificates of deposit that it obtained from various banks. ML purportedly promised to maintain a secondary market to guarantee purchasers liquidity for their deposits, and represented to purchasers that it had reviewed the financial soundness of the issuing banks. The Second Circuit Court of Appeals began its analysis by analogizing the CDs offered in *Gary Plastics* to “investment contracts.”[9] An instrument is an “investment

[4] In some instances, the promise to maintain a secondary market can be problematic. For example, in the *Gary Plastics* case (discussed below), the Second Circuit viewed the promise to maintain a secondary market as a factor in its conclusion that the CDs offered by Merrill Lynch were “securities,” and therefore subject to registration under U.S. federal securities law.
[5] 455 U.S. 551 (1982).
[6] In contrast, the Court noted that holders of an ordinary long-term debt obligation assume the risk of the borrower’s insolvency.
[7] 455 U.S. at 558, 560 n. 11.
[8] 756 F.2d 230 (2d Cir. 1985).
[9] “Investment contracts” fall within the 1933 Act’s definition of “security.”

contract" if it evidences: (1) an investment; (2) in a common enterprise; (3) with a reasonable expectation of profits; and (4) to be derived from the entrepreneurial or managerial efforts of others.[10] Due to the fact that the broker's creation and maintenance of a secondary market was a critical part of its marketing efforts, and permitted investors to make a profit from these investments, the additional protection of the 1933 Act was deemed appropriate.

As one result of this case, while brokers who offer these products indicate that they *may* make a secondary market in them (and in fact many do), these issuances do not involve a commitment or an agreement on the part of any broker to do so.

Office of Comptroller of the Currency

Issuing banks regulated by the U.S. Office of the Comptroller of the Currency (the "OCC") may need to comply with the registration requirements set forth by the OCC. The OCC's securities offering disclosure regulations provide that, absent an available exemption, no bank may offer or sell securities without meeting the registration and delivery requirements under 12 C.F.R. 16 ("Part 16").[11] The registration requirements under Part 16 are similar in many respects to those of the 1933 Act, and the requirements apply to any bank-issued instrument characterized as a "security." In making such determination as to CDs, the OCC applies an analytical framework that is comparable to that set forth in the *Marine Bank* and *Gary Plastics* cases. As a result, most FDIC-insured structured CDs issued by banks are exempt from registration under the OCC's rules.

Blue Sky Laws

Since SCDs are usually not considered securities, they fall outside of the registration requirements imposed by each state's blue sky laws. Further, under the National Securities Markets Improvement Act of 1996, federal law preempts the application of blue sky laws to certain categories of securities, known as "covered securities." Included in the definition of "covered securities" are certain securities exempt under Section 3 of the 1933 Act. These include any security issued or guaranteed by any bank. Because they are issued by banks, SCDs also would be considered "covered securities" (if they were securities) and fall outside of the purview of blue sky laws.

Offering Documents for CDs

Special consideration is given to the disclosures that issuing banks should make in connection with offerings of SCDs.

Although SCDs are not generally considered securities, many issuing banks document and market them in a manner similar to that used for medium-term notes. For the SCDs of larger, more frequent issuers, the related documents that are prepared and distributed to investors are similar to those used in registered structured note offerings. For example, an issuer may provide its SCD investors with a "pricing supplement," which sets forth the specific terms of a particular SCD (including the terms of the SCD, a comprehensive discussion of the economic terms of the offering, a discussion of the market measure, specific risk factors,[12] fees and expenses), a "product supplement," and/or a base disclosure statement. The disclosure documents will also usually inform investors of the

[10] *SEC v. W.J. Howey*, 328 U.S. 293 (1946). This four-part test is commonly known as the "Howey test."
[11] Like the registration requirements under the Securities Act, Part 16 aims to provide the investing public with full disclosure of the material facts and circumstances regarding the offer and sale of securities by national banks.
[12] In March 2006, the NYSE issued information memorandum 06-12, in which it reminded member firms of their obligation to ensure that investors in SCDs understood the key risks of these products, whether by means of the SCD offering document, and/or by means of an oral discussion. This information memorandum may be found at: http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E8852571330062CAE1/$FILE/Microsoft%20Word%20-%20Document%20in%2006-12.pdf.

tax consequences of their investment. These tax consequences are often similar to those of a security with a comparable structure.[13]

By mirroring the types of disclosures traditionally found in medium-term note programs, an issuing bank can accomplish a number of objectives. First, the disclosures allow issuing banks to fulfill the disclosure requirements. Second, the disclosures provide investors with the level and quality of information that regulators have traditionally deemed adequate for investors to make an investment decision. Lastly, since many issuing banks and brokers that offer SCDs also offer structured securities programs, providing documentation for SCDs similar to that used for medium-term notes affords some level of familiarity to investors (as well as the financial advisors that market them).

The marketing process for SCDs can be similar to the process employed in medium-term note programs. Many banks that are frequent issuers of SCDs will market SCDs with specific structures, linked to different market measures. Like medium-term notes, an issuing bank can tailor an SCD offering to meet the needs of specific investors ("reverse inquiry transactions").

Issuing banks and broker dealers may also prepare other materials, including brochures and term sheets, to market SCDs. Because the SCDs are not securities, these documents are not subject to the SEC rules governing "free writing propsectuses."

Filing with FINRA

In September 2009, FINRA issued Regulatory Notice 09-55, requesting comments on proposed new FINRA Rule 2210 governing communications with the public by FINRA member broker-dealers. The proposed rule would amend the previous NASD Rule 2210 regarding filing requirements that brokers must comply with in connection with certain retail communications. Under the proposed new FINRA Rule 2210(c)(2), which could apply to SCDs, a broker must file retail communications with FINRA at least 10 business days prior to first use or publication, and may not publish or circulate such materials until any changes by FINRA have been made. Issuers of registered structured notes would be exempt from filing prospectuses under this rule, because those documents are filed with the SEC. However, no such exemption was included in the proposed rule for SCDs. Accordingly, brokers who sell SCDs may be required to file a substantial number of documents if the rules are adopted in their proposed form.

Regulation DD

Under Federal Reserve Regulation DD (which implements the Truth in Savings Act), issuing banks and brokers who offer CDs are required to make certain disclosures with regard to deposit accounts "held by or offered to" consumers in order to enable consumers to make informed decisions about these accounts. In general, Section 230.8 of Regulation DD prohibits an issuing bank from advertising its deposit accounts in any way that is inaccurate or misleading. The regulation contains a variety of specific disclosure rules. For instance, banks are prohibited from using the word "profit" in referring to interest payments. Banks are also obligated to comply with Section 230.8's advertising rules regarding rates of return. For example, an issuing bank must state the rate as an "annual percentage yield," and disclose any and all fees associated with the deposit, such as ladder rates on various CDs, as well as any penalty fees that may be imposed for early withdrawal.

Additional SCD Documentation

In offering SCDs, or creating an SCD program, a variety of additional agreements and documents are usually used:

- A brokerage or purchase agreement between the issuing bank and the brokers that will market them.
- A paying agency agreement with a paying agent (a third party financial institution), if one is used.

[13] For a summary of the tax consequences of structured notes generally, see MoFo Tax Talk, "The Learning Annex: A Taxonomy for Structured Notes—Type 1, Type 2 and Type 3 Notes" at http://www.mofo.com/files/Publication/9a9d7af5-1e51-426f-b965-a4d37fd47c8b/Presentation/PublicationAttachment/f6d9f4ee-b98c-4fd9-8729-61462ec5d155/080307TaxTalk.pdf.

- One or more forms of master certificates that represent the SCDs.
- Documentation providing for the clearance of the SCDs through the facilities of the Depository Trust Company (DTC).
- Where the issuing bank hedges its obligations under the SCDs, appropriate agreements with one or more hedging counterparties.

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SCDs have become a significant part of the structured product landscape. SCDs have proven to be a useful means for investors to accomplish many of their investment goals, and to help banks and brokers meet the needs of their customers.

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