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Structured Thoughts

News for the financial services community.

FINRA Issues Notice to Members re Principal Protected Structured Notes 1
Leveraged and Inverse Exchange-Traded Funds 2
SEC Adopts as Final Rule 206(3)-3T 4

FINRA Issues Notice to Members re Principal Protected Structured Notes

In December 2009, FINRA issued its regulatory notice no. 09-73, relating to principal protected notes. The main portion of the notice is to remind FINRA members of potential disclosure issues with respect to principal protected (and "partially principal protected") products, and products that are marketed with similar terms.

The notice may be accessed via FINRA's website:
http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120596.pdf

In particular, the notice reminds FINRA members to ensure that their promotional materials and communications with the public contain clear and properly-balanced disclosures as to the nature of the principal protection that a product may offer. Appropriate disclosures should include:

- the degree of principal protection;
- the credit risk of the issuer and any guarantor;
- any limitations on a product's upside potential;
- any limitations on the investor's ability to receive the return of his or her funds prior to maturity; and
- any costs or fees that might affect the return of principal.

The notice reflects ongoing concerns in the structured products market arising from the credit crisis, and the demise of Lehman Brothers and Bear Stearns. Disclosure issues relating to Lehman Brothers' "principal protected notes" have become the focus of securities regulators from Hong Kong to New Hampshire. As a result, even prior to the issuance of the notice, many issuers and underwriters of structured products began to reconsider and revise their prospectuses and other marketing materials to clarify the meaning of "principal protected," and to enhance the disclosures of the related risks.

In addition to these disclosure issues, the notice reminds FINRA members to review the suitability of these products for investors, and to ensure proper training of their personnel, prior to making a recommendation of these products.

Leveraged and Inverse Exchange-Traded Funds

Background

An exchange-traded fund ("ETF") allows an investor to buy and sell shares in a single security that represents a fractional ownership interest in a pool of securities and other assets. An ETF originates with a sponsor who chooses an ETF's target index or investment objective and policies, determines which securities will be included in the portfolio of securities, and decides how many ETF shares will be offered to investors. Unlike an exchange-traded note ("ETN"), which is an unsecured promissory note of a bank or other sponsor where the sponsor does not establish a separate entity to issue the notes and to acquire a portfolio of securities to backstop its obligations, an ETF issuer is a separate entity from the sponsor and is not subject to claims of the creditors of the sponsor. The table below is a summary comparison of ETFs to ETNs.

	ETNs	ETFs
Issuer:	Registered under the Securities Act of 1933	Registered investment company under the Investment Company Act of 1940
Security:	Debt security; senior, unsecured claim of the issuer	Equity (ownership) interest in a portfolio of securities (investors can request in-kind distributions)
Recourse:	Subject to issuer's credit risk (issuer default; value in part based on credit rating of the issuer)	Recourse to the portfolio of securities
Reference Asset:	Return of the benchmark index	Performance of the portfolio of securities
Principal Risk:	Principal at risk	Principal at risk
Liquidity:	Exchange-traded	Exchange-traded
Liquidation:	Investors do not receive underlying securities upon a redemption	Upon liquidation, investors will receive their *pro rata* share of the securities held.

ETFs are listed on a national securities exchange and can be bought and sold like common stock throughout the trading day. Typically, ETFs are either registered unit investment trusts or open-end investment companies that have obtained an exemptive order or other relief from the SEC.[1] Since March 2008, the SEC has considered a proposal that would allow ETFs to begin trading without the need to obtain individual exemptive orders.[2] The proposed rule would give ETFs even greater flexibility and "is designed to eliminate unnecessary regulatory

[1] Although the SEC views equity ETFs as being subject to the Investment Company Act of 1940, there is no explicit provision for them, and the SEC must issue an exemptive order for each proposed ETF. An ETF that meets the definition of "investment company" is registered under the Investment Company Act of 1940 generally because it issues securities and is primarily engaged in, or proposes to be primarily engaged in, the business of investing in securities. Some ETFs that invest in commodities, currencies, or commodity-based or currency-based instruments are not registered as investment companies. *See* SEC Rel. No. 33-8901, available at http://www.sec.gov/rules/proposed/2008/33-8901.pdf. Commodity-based ETFs are regulated by the Commodity Futures Trading Commission, although the SEC oversees such ETFs and must, nonetheless, provide exemptive relief for each such ETF.

[2] *See* SEC Rel. No. 33-8901, available at http://www.sec.gov/rules/proposed/2008/33-8901.pdf.

burdens, and to facilitate greater competition and innovation among ETFs."[3] ETFs can already do things that most mutual funds cannot, such as trading throughout the day on an exchange instead of at that day's closing price and using leveraged and inverse trading techniques in creative ways.

One permutation of the ETF structure is an ETF that seeks to produce a return that is a multiple of the return of its underlying index. Commonly known as a "leveraged" ETF, the ETF uses futures or other derivatives to multiply the daily return of the underlying index. An inverse (or "short") ETF is designed to correspond to the inverse of the daily performance of the underlying index. An ETF that is both leveraged and inverse seeks to deliver daily returns that are a multiple of the inverse of the daily performance of the underlying index.

Rebalancing with Leverage

Because leveraged ETFs are designed to generate daily returns that are a multiple of the daily return of the underlying index or the opposite of the daily return of the underlying index (in the case of inverse ETFs), these ETFs are reset each day.[4] As a result of the daily reset feature and the leveraging effect, the returns on a leveraged ETF over time can differ significantly from the performance (or inverse of the performance) of the underlying index during that same period. For example, assume on day 1 an index starts with a value of 100 and a leveraged ETF that seeks to double the return of the index (a "2x" leveraged ETF) starts at $100. If the index drops by 10 points on day 1, it has a 10% loss and a resulting value of 90. Assuming that the leveraged ETF achieved its stated objective, the leveraged ETF would, therefore, drop 20% on that day and have an ending value of $80. On day 2, if the index rises 10%, the index value increases to 99. For the leveraged ETF, its value for day 2 would rise by 20%, which means that the leveraged ETF would have a value of $96. On both days, the leveraged ETF produced daily returns that were two times the daily index returns. However, if one compares the results over the 2-day period: the index lost 1% (from 100 to 99), while the 2x leveraged ETF lost 4% (from $100 to $96). As a result, over the 2-day period, the leveraged ETF's negative returns were 4 times as much as the 2-day return of the index instead of 2 times the return.[5]

Regulatory Responses

Leveraged and inverse ETFs have attracted regulatory attention. In June 2009, the Financial Industry Regulatory Authority ("FINRA") issued a Regulatory Notice reminding brokers and securities firms of their "sales practice obligations in connection with leveraged and inverse ETFs."[6] Specifically, FINRA emphasized that recommendations to investors must be "suitable and based on a full understanding of the terms and features of the product recommended" and that securities firms must have "adequate supervisory procedures" in place to ensure that those obligations are met.[7] Citing the daily rebalancing feature of leveraged and inverse ETFs, FINRA stated that these ETFs are "typically … unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets."[8]

Subsequent to FINRA's June 2009 Regulatory Notice, the SEC and FINRA issued a joint alert on August 18, 2009 based on their belief that "individual investors may be confused about the performance objectives of leveraged and

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[3] *See* SEC Rel. No. 33-8901, at p.1, available at http://www.sec.gov/rules/proposed/2008/33-8901.pdf.
[4] However, some leveraged and inverse ETFs may move beyond daily resets. For example, in October 2009, Direxion, a provider of leveraged and inverse ETFs, announced that, in addition to its daily products, it was in the process of structuring ETFs that aim to provide leveraged returns on a monthly basis. *See* "Direxion Changes Investment Objective of Leveraged Index Mutual Funds," available at http://www.direxionfunds.com/pdfs/PR_DF_093009.pdf.
[5] The example is adapted from the August 18, 2009 "alert" issued by the SEC and FINRA to illustrate the performance objectives of leveraged and inverse ETFs. The alert is available at http://www.sec.gov/investor/pubs/leveragedetfs-alert.htm.
[6] FINRA Regulatory Notice 09-31, June 2009, available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118952.pdf.
[7] Id.
[8] Id.

inverse exchange-traded funds."[9] In particular, the agencies stated that some investors may have the incorrect "expectation that … ETFs may meet their stated daily performance objectives over the long term as well."[10]

On August 31, 2009, FINRA issued an additional Regulatory Notice in which, effective December 1, 2009, it increased the maintenance margin requirements for leveraged ETFs and associated uncovered options by a factor commensurate with their leverage.[11] The then current requirement for a leveraged ETF was 25% of the ETF's market value. The new rule increased that requirement to 50%. In a triple leveraged ETF, the requirement is now 75%. In an inverse ETF, the margin requirement was 30% of the ETF's value. Under the new rule, the requirement was doubled to 60%. The requirements will not exceed 100% of the ETF's market value.

State regulators also have recently focused on leveraged and inverse ETFs. In October 2009, the Kentucky Department of Financial Institutions and the Montana Commissioner of Securities and Insurance issued news releases that alleged that leveraged ETFs were a top "investor trap" that posed a threat to investors in 2009.[12]

Looking Ahead

The number of leveraged and inverse ETFs and the volume of their trading activity have grown substantially since the first leveraged and inverse ETFs were launched in 2006. As of November 1, 2009, there were 283 leveraged and inverse ETFs listed on Bloomberg, holding over $100 billion in assets. The total trading volume on November 1, 2009 exceeded 959 million shares. Faced with increased regulatory scrutiny, issuers and sponsors of leveraged and inverse ETFs have begun updating their offering documents to highlight the skewed risks attributable to those products. Financial institutions also have issued cautionary statements regarding those products.[13] Whether the use of leveraged and inverse ETFs will continue to grow in light of these efforts and despite the recent regulatory focus – including the not insubstantial new margin requirements – remains to be seen.

SEC Adopts as Final Rule 206(3)-3T

At the end of December 2009, the SEC adopted on an interim final basis Rule 206(3)-3T. The rule now expires on December 31, 2010. Rule 206(3)-3T had been adopted as an interim rule by the SEC in 2007 in order to provide an alternative means for investment advisers registered as broker-dealers to meet the requirements of Section 206(3) of the Advisers Act of 1940 ("Advisers Act") when they act in a principal capacity in transactions with certain of their advisory clients.

Background

Under Section 206(3) of the Advisers Act, an investment adviser acting as principal for its own account cannot (1) sell any security to, or purchase any security from, a client, or (2) acting as a broker-dealer for a person other than the client, effect any sale or purchase of any security for the account of the client, without (a) disclosing to the client in writing, prior to the completion of the transaction, the capacity in which it is acting, and (b) obtaining the client's consent for the transaction, unless the investment adviser is not acting as such in connection with the transaction.

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[9] The alert is available at http://www.sec.gov/investor/pubs/leveragedetfs-alert.htm.
[10] Id.
[11] FINRA Regulatory Notice 09-52, August 2009, available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p119906.pdf.
[12] The news release from the Kentucky Department of Financial Institutions is available at http://migration.kentucky.gov/newsroom/eppc_ofi/traps101409.htm; the news release from the Montana Commissioner of Securities and Insurance is available at http://sao.mt.gov/news/20091009Traps.html.
[13] The announcement by Fidelity Investments is available at http://personal.fidelity.com/research/etf/content/leveraged_etn_etf.shtml.cvsr; the warning by Charles Schwab is available at http://www.schwab.com/public/schwab/research_strategies/market_insight/investing_strategies/exchange_traded_funds/leveraged_and_inverse_etfs_not_right_for_everyone.html.

The SEC adopted Rule 206(3)-3T in order to provide investment advisers that are dually registered as broker-dealers ("Dual Registrants") limited relief from the principal trading restriction under Section 206(3). The rule enables fee-based brokerage customers to convert their accounts to fee-based accounts subject to the Advisers Act or to commission-based brokerage accounts.

Rule 206(3)-3T

Under Section 206(3) of the Advisers Act, Dual Registrants must provide written notice and obtain client consent on a transaction-by-transaction basis when trading as a principal with a client. Rule 206(3)-3T provides Dual Registrants with an alternative means to comply with Section 206(3), while still requiring transaction-by-transaction disclosure. Specifically, the Rule permits a Dual Registrant to engage in principal transactions with a non-discretionary advisory client, subject to the following conditions:

- *Blanket Written Notice and Revocable Consent.* The Rule requires the Dual Registrant to provide the client with a blanket written prospective notice and obtain the client's blanket written revocable prospective consent with respect to principal transactions.
- *Eligible Securities.* The Rule applies to any principal trade that does not involve (1) a security issued by the Dual Registrant (or by an affiliate of the Dual Registrant), or (2) a transaction in which the Dual Registrant (or an affiliate of the Dual Registrant) acts as underwriter, other than offerings of non-convertible investment grade debt securities.[14]
- *Trade-by-Trade Disclosure/Client Consent.* The Rule requires that the Dual Registrant, prior to the completion of each principal transaction, (1) inform the client that the Dual Registrant is acting as principal for its own account with respect to the transaction, and (2) obtain the consent from the client for the transaction. The trade-by-trade disclosure and consent may be written or oral.
- *Confirmation Disclosure.* The Rule requires that the confirmation provided to the client under Rule 10b-10 of the Exchange Act, at or before completion of the transaction, indicate in Plain English that (1) the Dual Registrant disclosed to the client prior to the execution of the transaction that it may act in a principal capacity in connection with the transaction, (2) the client authorized the transaction, and (3) the Dual Registrant sold the security to or purchased the security from the client for its own account.
- *Annual Report.* The Rule requires that the Dual Registrant provide the client with list of all principal trades that were executed in the client's account during the prior year, including the date and price of the transactions.

Investment advisers that trade in securities issued by, or underwritten by, affiliates, should be mindful that these securities are not eligible securities (as discussed above) and therefore, the investment adviser must obtain consent for each transaction on a trade-by-trade basis. The Rule does not relieve any investment adviser of its fiduciary obligations under the Advisers Act or other applicable provisions of federal law. The SEC will continue to study how the rule is being used and will also consider the rule in light of proposed legislative changes, such as those that would take effect in connection with the Investor Protection Act.

[14] It is important to note that under the Interim Rule, the exemption for non-convertible investment grade debt securities underwritten by an affiliated broker-dealer does not extend to structured products that are investment grade debt. Thus, for principal trades in structured products underwritten by an affiliate, the investment adviser must obtain consent on a trade-by-trade basis.

Attorney Advertisement

Contacts

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