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Structured Thoughts

News for the financial services community.

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Securities and Exchange Commission Tackles Fund Use of Derivatives

On August 31, 2011, the Securities and Exchange Commission (the "SEC") published a Concept Release and requested comments on issues concerning the use of derivatives by investment companies, including mutual funds, closed-end funds, exchange-traded funds and business development companies. Although the Concept Release makes few specific proposals, it lays the groundwork for future action that could change the regulatory landscape affecting funds that use derivatives. At this stage, it is unclear whether the SEC will focus solely on derivatives, or whether the SEC will consider the use of structured products by funds.

The Concept Release appears to be motivated by a belief that the time is ripe for a comprehensive SEC review of how funds use derivatives. The Concept Release states that the SEC seeks to evaluate whether the existing regulatory framework, as it applies to funds' use of derivatives, continues to fulfill the purposes and policies underlying the Investment Company Act of 1940 (the "1940 Act") and is consistent with investor protection.

The Concept Release states that funds using derivatives must consider, among other things:

- Leverage limitations in Section 18 of the 1940 Act that apply to funds;
- Portfolio diversification;
- Industry concentration;

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- Investment in securities-related issuers;
- Valuation;
- Accounting and financial reporting; and
- Disclosures.

The Concept Release recognizes that compliance with these statutory and regulatory restrictions may be difficult because derivatives may involve multiple risk exposures and values must be assigned to each exposure. The Concept Release discusses OTC and exchange-traded derivatives. For a complete discussion of the Concept Release, see our alert at http://www.mofo.com/files/Uploads/Images/110906-SEC-Tackles-Fund-Use-of-Derivatives.pdf. It seems likely that the SEC will take some action to address these concerns, but it is equally likely that the issues discussed in the Concept Release will generate a significant number of substantive comments. It will take the SEC and its staff a considerable amount of time and effort to sort through and evaluate these comments. We will monitor the developments related to this Concept Release and the potential impact on structured products.

Watch the CDS Spreads

In recent months, CDS spreads for financial institutions, including those for U.S. banks, have widened. Whether one believes that the CDS spreads have widened principally due to concerns about the sovereign crisis in Europe, or as a result of the continuing saga of mortgage related litigation in the United States, it is important that issuers and distributors of structured products monitor these developments. In a recent FINRA consent order (discussed in a prior issue http://www.mofo.com/files/Uploads/Images/110825-Structured-Thoughts.pdf), FINRA noted that the broker-dealer should have been monitoring CDS spreads for the issuers of the structured products in question. CDS spreads are but one reflection of perceptions regarding credit risk. In drafting offering disclosure or in reviewing offering disclosure regarding structured product issuances, careful attention should be paid to the discussion of the issuer's business condition, credit quality and any risks related to these circumstances. In rapidly evolving markets, disclosure may need to be updated with some frequency. Dealers and distributors will also want to bear in mind that investors may have questions concerning issuer credit risk, and that they should ensure their customers are aware of the role that changing credit risk plays in assessing the riskiness of a particular investment.

Back-Testing

Much of the product development work in the last year in the structured products market has been focused on index creation and the structuring of products linked to proprietary indices. As index-linked products continue to be introduced, we are receiving more inquiries from clients regarding back-testing of index performance.

A number of questions arise in connection with including historical data (whether hypothetical or actual) regarding index performance. The SEC has not directly addressed the issue of back-testing in connection with structured products, although one can intuit many issues that are likely to cause regulatory concern and perhaps even analogize to SEC Staff guidance provided in other areas.

The first and most obvious concern is to ensure that if back-testing information is presented, it is fairly presented. In other words, to the extent historical data is shown, the issuer should make sure that it is providing performance for a representative period, and not tailoring the presentation to show the most favorable performance results. Also, depending on the type of index, the period presented may not be long enough to evidence index performance during varying market phases. Second, the historical data should be accurately described—for example, is it data that is

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re-created for an index that was just recently introduced, or is it actual historical performance? Third, the issuer will want to accompany the performance information with explanatory disclosure that is balanced. The disclosure should note that the information is indicative performance data only. Moreover, the disclosure should note any special circumstances or factors that would limit the predictive value of the information. In other contexts in which the SEC has addressed performance results, the SEC has advised that results be accompanied by prominent disclaimers to the effect that past performance is not indicative or suggestive of future results. In the context of a structured product, any discussion of index performance should be balanced. It should be clear to any potential investor that the performance of the index is but one factor that the investor should consider in making its investment decision. The investor will also want to take into account all of the risks relating to the index as well as the payout structure of the offered product and the credit risk of the issuer (among other factors). Regulators have also expressed concerns regarding whether investors in structured products fully appreciate that most products are buy-and-hold products. Accordingly, the disclosure may also state that the data only provides a historic perspective on product performance if the instrument were held to maturity.

Some insight may be gleaned from the SEC Staff's views on performance measures in other contexts, including fund products and variable annuity type products. For those products, the SEC cautioned that any performance based advertising should not be false or misleading and should not create unrealistic investor expectations. The SEC Staff noted that portrayals of past performance might be misleading if they omit appropriate explanations and qualifications regarding the information that is presented. Also, information might be misleading if additional detail is omitted in the case where historical performance is presented only as to particular periods. The Staff also required the inclusion of disclaimer language regarding past performance, as well as enhanced disclosure of risks, fees, expenses or other costs that might affect future returns or impact a potential investor's investment decision. Finally, in this context, the Staff also focused on the prominence of certain disclosures and the proximity of the discussions relating to benefits compared to those disclosures relating to risks or other warnings. Given FINRA's focus on fair and balanced language and on the prominence/proximity of certain types of disclosures, these considerations should be familiar to those drafting structured product disclosures.

In certain countries, regulators have objected to back-testing, while in others some measure of back-testing is required. Interestingly, the many regulatory reviews relating to retail structured products in Europe (including the Retail Distribution Review and the PRIPs consultation) do not address back-testing. We will be monitoring new guidance on back-testing.

SEC Extends Sunset of Rule 206(3)-3T; Staff Study Will Shape Future Regulation of Principal Transactions

In December 2010, the Securities and Exchange Commission extended an interim final rule regulating an investment adviser's principal transactions with its clients. The SEC extended Rule 206(3)-3T until December 31, 2012.[1]

The SEC initially adopted Rule 206(3)-3T as an interim rule in 2007 in order to provide an alternative means for investment advisers registered as broker-dealers to satisfy 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. We previously discussed the rule and proposed amendments to the rule in our January 12, 2010 and December 14, 2010 editions of "Structured Thoughts,"[2] and have included a summary of the rule below.

[1] The adopting release may be found at: http://www.sec.gov/rules/final/2010/ia-3128.pdf (the "Adopting Release").
[2] Available at: http://www.mofo.com/files/Publication/d3eca515-40a4-4991-adfc-780d3a840532/Presentation/PublicationAttachment/5cab055d-f9d3-4a08-9bfe-d1cf7e9ec618/100112Structured_thoughts_newsletter_vol_1.pdf and http://www.mofo.com/files/Uploads/Images/101214-Structured-Thoughts.pdf.

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The SEC extended the sunset of Rule 206(3)-3T in anticipation of the publication of its staff's Study on Investment Advisers and Broker-Dealers, including the standard of care that should apply to them. The Study, published in January 2011, recommended, among other things, that a uniform fiduciary standard should apply to both broker-dealers and investment advisers that provide personalized investment advice about securities to retail customers, no less stringent than the standard currently applied to investment advisers. Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") mandated the Study.[3]

The SEC stated in the Adopting Release that "firms' compliance with the substantive provisions of rule 206(3)-3T provides sufficient protection to advisory clients to warrant the rule's continued operation while we conduct the study mandated by section 913 of Title IX of the Dodd-Frank Act and consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers."[4] The SEC also noted that, as part of its broader consideration of regulatory requirements applicable to broker-dealers and investment advisers, it "intend[s] to carefully consider principal trading by advisers, including whether Rule 206(3)-3T should be substantively modified, supplanted, or permitted to expire."[5]

As a key feature of its determination, the SEC noted that in connection with its examination of brokers' activities under the rule, its staff did not identify any cases of "dumping" securities into accounts covered by the rule.[6] (However, the SEC did note that the staff had encountered a variety of compliance issues of concern,[7] and was taking a variety of actions to address them, including referrals to its Division of Enforcement for possible enforcement action if warranted).

Background

Section 206(3) of the Advisers Act provides that 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) act 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. The SEC adopted Rule 206(3)-3T in order to provide limited relief to investment advisers that are dually registered as broker-dealers ("Dual Registrants") 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.

Background of 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

[3] The Staff's study can be found at: http://www.sec.gov/news/studies/2011/913studyfinal.pdf (the "IA/BD Study").
[4] Adopting Release at 4.
[5] Adopting Release at 5; IA/BD Study at fn 533.
[6] Adopting Release at 8.
[7] Adopting Release at 6.

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an affiliate of the Dual Registrant) acts as underwriter, other than offerings of non-convertible investment grade debt securities.[8]

- *Trade-by-Trade Disclosure/Client Consent.* The Rule requires that the Dual Registrant, prior to the completion of each principal transaction, must (1) inform the client that the Dual Registrant is acting as principal for its own account with respect to the transaction and (2) obtain 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 a list of all principal trades that were executed in the client's account during the prior year, including the dates and prices 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 in connection with its work under the Dodd-Frank Act.

Looking Ahead

Section 913(g) of the Dodd-Frank Act requires that the standard of conduct applicable to broker-dealers should be "no less stringent" than that required by Sections 206(1) and (2) of the Advisers Act. Conspicuously omitted from this congressional mandate is a reference to Section 206(3) of the Advisers Act, apparently reflecting a congressional intent not to mandate the application of that provision to broker-dealers that provide personalized investment advice about securities to retail investors.

The SEC's staff in the IA/BD report, however, concluded that principal trades by broker-dealers "raise the same potential conflicts of interest as such trades by investment advisers and thus implicate the duty of loyalty included in the uniform fiduciary standard" mandated by Section 913(g) of the Dodd-Frank Act. Accordingly, the staff recommended that the SEC address through guidance or rulemaking how broker-dealers would fulfill the uniform fiduciary standard when engaging in principal trades, especially trades involving fixed income securities, including municipal bonds.[9] When the SEC considers whether to extend Rule 203(3)-3T beyond 2012, it is likely to embrace the staff's recommendations.

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[8] As noted above, 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.
[9] IA/BD Report at 119-120.

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Morrison & Foerster named Structured Products Firm of the Year, Americas, 2011 by *Structured Products* magazine.

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