

# Structured Thoughts

News for the financial services community.



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## Final TLAC Rules and Structured Products

On December 15, 2016, the Board of Governors of the Federal Reserve System (the “Federal Reserve”) issued its final rules regarding long-term debt and total loss absorbing capacity (“TLAC”) requirements for global systemically important banks (“G-SIBs”) in the United States. In this article, we discuss the effect of these rules on the U.S. structured products market.

For our firm’s client alert on the final TLAC rules, please see the following link: <https://media2.mofo.com/documents/161215-federal-reserve-final-tlac-rule.pdf>.

Generally speaking, the final rules are consistent with the 2015 proposed rules, with some important modifications for the intermediate holding companies (“IHCs”) of foreign banking organizations (“FBOs”) that are G-SIBs and are subject to an IHC requirement.

*Structured Notes Will Not Be Included in TLAC.* As most observers expected, eligible external long-term debt instruments do not include most structured notes, as they are not “plain vanilla” debt securities. The Federal Reserve continues to believe that the complexity of these instruments would diminish the prospects for an orderly resolution of a bank holding company.

*What Is a Structured Note?* Under the final rules, the definition of “structured note” remains largely consistent with the 2015 proposals. A “structured note” is a debt instrument that:

- has a principal amount, redemption amount, or stated maturity that is subject to reduction based on the performance of any asset, entity, index, or embedded derivative or similar embedded feature;
- has an embedded derivative or similar embedded feature that is linked to one or more equity securities, commodities, assets, or entities;

- does not specify a minimum principal amount that becomes due upon acceleration or early termination; or
- is not classified as debt under GAAP.

(The first two bullets above encompass most of the relevant types of instruments in the U.S. market.)

In response to comments on the 2015 proposed rules submitted by the Structured Products Association, the definition of a structured note *does not include* a non-dollar-denominated instrument or an instrument whose interest payments are based on an interest rate index (for example, a floating-rate note linked to the federal funds rate or to LIBOR) that otherwise satisfies the requirements. Accordingly, a variety of common “lightly structured notes,” such as “fixed-to-floating rate notes,” that are issued both in and outside of the United States would be eligible long-term debt. However, as discussed below under “—Early Acceleration Clauses” and “—Governing Law,” many issuers will not be able to continue their historical issuances in the same manner as they have done in the past.

*What Is an Interest Rate Index?* For purposes of determining whether a debt security is a “structured note,” the rules do not define the term “interest rate index,” as used in the preceding paragraph. The Federal Reserve cited as examples in its materials each of the federal funds rate and LIBOR. We believe that widely followed, or “benchmark,” interest rates, such as CMS, that are calculated and reported by independent third parties should fit this description; in particular, a note linked to such a rate does not have the characteristics of a reference asset of the type contemplated by the second bullet above.

We would point out that a note that is linked to the federal funds rate or LIBOR that is not principal protected would be considered a “structured note” under the first bullet in the definition set forth above, and would not be eligible. Such a note would have a payment at maturity that is subject to reduction based on an embedded derivative.

*No Relief for Principal Protected Structured Notes.* Notwithstanding the concerns and comments of market participants, the exclusion from the eligibility requirements for notes linked to equities, commodities and other assets applies both to “principal protected” and to “non-principal protected structured notes.” According to the Federal Reserve:

“Structured notes with principal protection often combine a zero-coupon bond, which pays no interest until the bond matures, with an option or other derivative product, whose payoff is linked to an underlying asset, index, or benchmark. [footnote omitted] The derivative feature violates the intent of the clean holding company requirements..., which prohibits derivatives entered into by the covered bank holding company with third parties. Moreover, investors in structured notes tend to pay less attention to issuer credit risk than investors in other long-term debt, because structured note investors use structured notes to gain exposure unrelated to the covered BHC. As a result, these investors are less likely to contribute to the market discipline objective of the minimum LTD requirements.”

*No Grandfathering for Most Structured Notes.* Due to the Federal Reserve’s concerns about structured notes, outstanding instruments of this kind will not be “grandfathered” as external TLAC. The Federal Reserve states that it does not expect this limitation to have a significant impact on banks, particularly in light of the grandfathering of other long-term debt, such as notes with early acceleration features, or that are governed by non-U.S. law.

*Early Acceleration Clauses.* Eligible long-term debt may not have an acceleration clause that provides a contractual right for the holder to accelerate payment, except for a failure to make payments or an insolvency event. As we have previously noted, the indentures for most outstanding U.S. and other medium-term note programs contain acceleration clauses for a variety of additional circumstances, such as the sale of a material bank subsidiary or a failure to maintain a corporate office. Accordingly, in order to enable issuers to more readily comply with the new rules, existing long-term debt of this kind is grandfathered under the new rules if issued before December 31, 2016. However, after that date, without an amendment to the relevant indentures governing debt issuances, newly issued debt securities with other acceleration features would need to be issued out of a finance or other subsidiary.

It remains to be seen whether investors in holding company debt would be prepared to invest in “plain vanilla” or other debt that does not have an acceleration clause for the failure to observe the non-payment covenants in an indenture. Accordingly, even though, as discussed above, lightly structured notes would be eligible long-term debt, it remains to be seen whether issuers will continue to issue them from the holding company.

*Governing Law.* To qualify as eligible long-term debt, the relevant instruments must be governed by U.S. law. Due to the amount of outstanding issuances that are governed by laws of jurisdictions, such as the U.K., Japan and Australia, outstanding issuances that otherwise qualify will be grandfathered, if issued prior to December 31, 2016.

*Survivor's Options.* Under the final rule, debt with a survivor's option would be treated as having matured on the first day that it is subject to the investor's option. This would be the date of issuance for most of these instruments. Accordingly, securities with a survivor's option will not qualify as eligible long-term debt, which must have a term to maturity of at least one year. This type of debt, if already outstanding, will not be subject to the grandfathering provisions.

*Structured Notes (and CDs) Issued by Subsidiaries.* Since the rules apply at the bank holding company level only, these rules will generally not affect structured bank notes or "structured CDs" issued by a bank subsidiary. And to avoid any misunderstanding, the adopting release notes specifically that "[t]he cap [on liabilities of bank holding companies] does not limit a covered BHC's ability to issue structured notes out of subsidiaries." Of course, a significant number of G-SIBs have established financing subsidiaries that issue structured products, and we anticipate that these entities will continue to operate in the manner initially envisioned.

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## IRS Provides Guidance on TLAC

On December 16, 2016, the IRS issued a Revenue Procedure which provides that certain instruments issued by global systemically important banking organizations ("GSIBs") that provide total loss-absorbing capacity ("TLAC") will be treated by the IRS as indebtedness for federal income tax purposes. This IRS guidance follows on the heels of the Federal Reserve's issuance of its final TLAC regulations.

In particular, the IRS guidance addresses internal TLAC that is issued to a non-U.S. GSIB by its U.S. intermediate holding company ("IHC").

Although TLAC is issued in the form of debt for state law purposes, tax commentators have questioned whether debt issued with certain features, such as a debt conversion feature, would qualify as indebtedness for federal income tax purposes. The Revenue Procedure provides that internal TLAC that is issued by an IHC of a foreign GSIB under the new rules will be treated by the IRS as indebtedness for federal tax purposes, to the extent the instruments have not been converted into equity.

For additional information and discussion, please see our client alert, which may be found at the following link: <https://media2.mofo.com/documents/161221-irs-guidance-tlac.pdf>.

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## DTC Announces New Eligibility Procedures for Section 871(m) Transactions

In October 2016, The Depository Trust Company ("DTC") announced that it is adjusting its eligibility procedures to comply with Section 871(m) of the Internal Revenue Code of 1986, as amended (the "Code"). Beginning on January 1, 2017, for securities to become and remain DTC "eligible securities," issuers will need to comply with DTC's new procedures.

DTC's announcement may be found at the following link: [www.dtcc.com/~media/Files/pdf/2016/10/31/4463-16.pdf](http://www.dtcc.com/~media/Files/pdf/2016/10/31/4463-16.pdf).

The new procedures will apply to any securities, including structured notes, that are treated as a "Section 871(m) transaction" under the Code and U.S. Treasury Regulations.

### Background

Section 871(m) of the Code generally treats "dividend equivalents" paid under securities lending transactions, sale-repurchase transactions and certain notional principal contracts as dividends from sources within the United States and therefore subject to U.S. withholding tax. The dividend equivalent rules are meant to prevent foreign investors from avoiding U.S. federal withholding taxes typically applicable to investments in U.S. securities by investing instead in derivatives linked to U.S. securities. In December 2013, the Internal Revenue Service (the "IRS") issued proposed

Treasury Regulations under Section 871(m) (the “Proposed Regulations”), designed to broaden Section 871(m)’s scope beyond transactions specifically described in the statute.<sup>1</sup>

In September 2015, the IRS finalized the Proposed Regulations, with significant changes (the “Final Regulations”).<sup>2</sup> The Final Regulations generally adopt the “delta” approach introduced in the Proposed Regulations, which treats payments on notional principal contracts (“NPCs”) and equity-linked instruments (“ELIs”) as dividend equivalents if they have a delta meeting a threshold.<sup>3</sup> However, the delta approach is limited to “simple” NPCs and ELIs, and a new framework has been designed for “complex” NPCs and ELIs. Originally, the Final Regulations had an effective date that was graduated over 2015, 2016 and 2017, but the IRS extended the effective date so that the Final Regulations would only apply to payments made on or after January 1, 2017, for any transaction issued on or after January 1, 2017.

Recently, on December 2, 2016, the IRS released Notice 2016-76, which announced that the effective dates of the Final Regulations would be further staggered. The notice, discussed in the prior article in this issue, announces that the IRS intends the effective date for the application of the Final Regulations to be on January 1, 2017 for delta-one instruments and January 1, 2018 for non-delta-one instruments.

### Initial Eligibility

For a security to qualify as DTC eligible, an officer of the issuer will be required to attest to the applicability of compliance with Section 871(m). The officer will be required to certify if the security is treated as a “Section 871(m) transaction”; if it is such a transaction, the officer must then certify whether it is a “simple contract” or a “complex contract.”<sup>4</sup> If the security is treated as a “simple contract,” then the applicable “delta” will also be required to be provided. In connection with the initial qualification, the officer must also agree that the issuer will provide DTC with dividend equivalent payments as they occur. (See “Maintaining Eligibility,” below.)

These certifications will be made by completing a template form of “Representations for Internal Revenue Code Section 871(m)” provided by DTC, which will be submitted with the eligibility request.

DTC has warned market participants that the failure to timely comply with this new attestation requirement may result in a delay in DTC approval. Of course, a delayed approval could result in delayed settlements, and issuers and underwriters will want to update their procedures to be in compliance at the beginning of 2017.

### Maintaining Eligibility

For securities that are considered “Section 871(m) transactions,” issuers will be required to provide DTC Dividend Equivalent Payments (“DEPs”) as they occur during the term of the security. DTC has created an “871(m) Dividend Equivalent Payment” template that sets forth the data that is required for the processing of these payments. As the DEPs occur, issuers will need to send this information to a designated DTC e-mail address.

### Getting Ready for January 2017

Historically, the DTC eligibility process was completed by the relevant distributors, without significant participation from the applicable issuers. The new required procedures, especially for frequent issuers, will require ongoing involvement from the relevant officer or officers from the issuers who make the required certifications, and accordingly, will want to establish a means to reliably verify their accuracy. Together with their tax advisors and underwriters, these issuers will need to establish procedures to ensure that the certifications can be accurately completed on a timely basis, and that any required periodic notifications can be made to DTC.

<sup>1</sup> For a more detailed discussion of the Proposed Regulations, see our Client Alert, available at <http://media.mofo.com/files/uploads/Images/131212-IRS-Regulations.pdf>.

<sup>2</sup> For a more detailed discussion of the Final Regulations, see our Client Alert, available at <https://media2.mofo.com/documents/150921dividendequivalent.pdf>.

<sup>3</sup> Under the Final Regulations, the delta threshold is 0.8 or greater.

<sup>4</sup> A complex contract is any NPC or ELI that is not a simple contract; a simple contract is an NPC or ELI that has a fixed term and references a fixed number of underlying shares.

## EU Regulatory Agenda: What to Expect in 2017

Well, 2016 was an eventful year in Europe. Despite the maelstrom caused by the UK “Brexit” vote, considerable work was done in continuing the implementation of the post-financial crisis regulatory agenda. New legislation that came into force included the Benchmark Regulation, which will have a significant impact on structured products. At the same time, there was a year’s delay in the implementation of two critical pieces of legislation: MiFID II/MiFIR and, right up to the wire, the PRIIPs Regulation. We set out below some of the ongoing events and regulatory developments that will continue to shape the structured products market in Europe into 2017.

**Brexit:** On 23 June 2016, the UK voted in referendum to leave the European Union (“EU”). This outcome was generally a surprise to the financial markets and gave rise to immediate market volatility, particularly in relation to the pound, which fell heavily in value against the euro and dollar. The vote, however, has no immediate effect. The UK currently remains a member of the EU, and existing EU-derived laws and regulations continue to apply to the UK. To commence its exit from the EU, the UK government has to serve notice of its intention to leave under Article 50 of the EU Treaty. The UK then has two years to negotiate the terms of its exit with the EU. If no agreement is reached, then at the end of this period (assuming no extension is agreed), the UK will automatically leave the EU and its trading relationship with the EU will default to World Trade Organisation (“WTO”) rules. The UK Prime Minister, Theresa May, has indicated her intention that the Article 50 notice be served by the end of March 2017. The UK Supreme Court is currently considering whether such notice can be served by the UK government under its Royal Prerogative or whether the approval of the UK Parliament is necessary. The Supreme Court’s decision is expected in early 2017, but whatever the outcome, it is not expected to have a major impact on the timing of service of the Article 50 notice.

There is considerable uncertainty as to what the nature of the UK’s relationship with the EU will be, following its exit. In particular, it is currently unclear the extent to which the UK will seek, and the terms on which it will be able to agree, access to the EU single market for goods and services. It is, however, likely that financial services firms authorised in the UK will no longer be able to take advantage of the MiFID<sup>5</sup> “passport” and to the extent that a UK-regulated entity carries out financial services or activities in the EU, separate authorisation(s) may be necessary. It is possible that for certain services and activities, non-EU firms (including UK firms after Brexit) may be able to rely on “equivalence” provisions in MiFID II and other relevant EU legislation, which will avoid the need for a full authorisation in the EU. These provisions are, however, limited in scope – for example the new MiFID II legislation does not provide for an equivalence regime in respect of investment business with retail clients.

To date, it does not appear that the Brexit vote has had a major impact on the structured products industry in the UK and the rest of the EU. Most of the impact so far has been felt through the market volatility and downward pressure on sterling caused by the outcome of the referendum. Although market participants will be looking closely at the ultimate outcome of the Brexit negotiations, it is worth noting that many structured products in Europe, particularly retail products, are sold within a single jurisdiction and the cross-border implications of Brexit may not be as acute for structured products as for the wider wholesale financial securities markets. That said, there is likely to be a significant impact for structured products that use a UCITS wrapper if the UCITS fund is located in the UK or managed by a UK entity. UCITS funds are required to be domiciled within the European Economic Area (“EEA”) and to be managed by an entity also located in the EEA. Assuming, as seems likely, that the UK leaves the EEA as well as the EU, absent any specific agreement as part of the Brexit negotiations, new UCITS funds will no longer be able to be established in the UK or managed by a UK entity. The position as regards such funds already established or located in the UK at the time of Brexit is unclear.

**PRIIPs:** The regulation on key information documents (“KIDs”) for packaged retail and insurance-based investment products (“PRIIPs”) was to have become effective on 31 December 2016. However, due to a delay in finalising the Regulatory Technical Standards (“RTS”) setting out the detailed requirements for preparation of the KID, the implementation date has now been delayed until 1 January 2018.

Under the PRIIPs Regulation, when a person is advising on or selling a PRIIP to retail investors, a pre-contract KID must be provided to the investor. The Regulation contains detailed requirements as to the form and content of the KID. The draft RTS were first published by the European Supervisory Authorities (“ESAs”)<sup>6</sup> in November 2015. They focused, in particular, on the presentation and content of the KID (including methodologies for calculating and presenting risks,

<sup>5</sup> This refers to the Markets in Financial Instruments Directive and “MiFID II” refers to the amendments to and extension of MiFID that is now due to apply from January 2018. See below for a summary of MiFID II developments

<sup>6</sup> The ESAs comprise the European Banking Authority (“EBA”), the European Insurance and Occupational Pensions Authority (“EIOPA”) and the European Securities and Markets Authority (“ESMA”).

rewards and costs), the review, revision and republication of KIDs, and the conditions for fulfilling the requirement to provide the KID in good time. Following a consultation process and workshop for market participants, the EU Commission adopted the RTS in June 2016 and proposed a draft delegated regulation to give effect to them. However, echoing the concerns raised by a number of market participants and trade associations, the EU Parliament subsequently raised a number of issues on the draft RTS including the methodology for the calculation of future performance scenarios and the lack of detailed guidance on how the required “comprehension alert” should be structured. It formally rejected the proposed delegated regulation in September 2016 and the EU Commission subsequently agreed to the delay in the implementation date.

In its revised timetable, the EU Commission has indicated that the ESAs should submit revised RTS to it by the end of 2016 with a view to them being finalised within the first half of 2017. The EU Commission is also expected to issue further guidance on aspects of the PRIIPs Regulation and the RTS during the first half of 2017 in the form of Q&A. Although many market participants were well advanced in preparing their KID templates, the delay is generally welcome in the market. In particular, manufacturers of complex products were concerned with the prospect of the PRIIPs Regulation becoming effective without detailed guidance as to the contents of the KID. The delay will give product manufacturers more time to consider fully whether and how the requirements, in respect of the KID, can be applied in respect of certain products.

**Benchmark Regulation:** The use of benchmarks in financial transactions has been in focus in recent years, following alleged misconduct in relation to the setting of LIBOR and other financial indebtedness. In July 2013, the International Organisation of Securities Commissions (“IOSCO”) published principles for financial benchmarks, and later that year, the European Commission published a draft regulation in relation to indices used as benchmarks in financial contracts, with the aim of reducing the risk of manipulation by ensuring that benchmark providers in the EU have prior authorisation and are subject to supervision. The subsequent legislative process was lengthy and involved significant amendments to the initial draft. The final regulation (the “Benchmark Regulation”) came into force on 30 June 2016, although most of its provisions will not become effective until January 2018.

The Benchmark Regulation takes a different approach from existing benchmark regulation in a number of jurisdictions (including the UK), which has focused principally on widely used benchmarks. Instead, the Benchmark Regulation will apply to a very wide range of indices, including proprietary indices, which are used as benchmarks in a wider range of financial instruments or investment funds. The Regulation requires administrators of benchmarks that are located in the EU to be authorised or registered by their relevant competent authority. Such benchmark administrators are subject to a number of obligations, including governance requirements, oversight function obligations and record-keeping. Additional requirements apply to administrators of commodity and interest rate benchmarks. Benchmarks that are regarded as “critical” (determined by specified criteria, including that the benchmark is used as a reference for financial instruments having a total value of at least €500 billion) are subject to additional requirements, particularly where the administrator of such benchmark intends to cease to provide such benchmark.

The Benchmark Regulation is particularly significant for structured products sold in the EU, as a supervised entity will only be permitted to “use” a benchmark in the EU (which includes the issuance of a financial instrument referencing a benchmark or determining the amount payable under a financial instrument or contract by reference to a benchmark) if it is provided by an administrator authorised or registered under the Benchmark Regulation. For administrators located outside of the EU, the Regulation provides various routes under which they can come within the scope of the Regulation. This will generally require the administrator to be authorised in a jurisdiction with equivalent regulation or to comply with the vast majority of the provisions of the Benchmark Regulation.

ESMA has published a Consultation Paper on draft RTS which provide further detail on certain aspects of the Benchmark Regulation, including the circumstances in which an index will be regarded as having been made available to the public. It is expected that the final version of the RTS will be submitted to the EU Commission by April 2017 with a view to being finalised well in advance of the 1 January 2018 implementation date.

**EMIR:** The European Market Infrastructure Regulation (“EMIR”), providing for the regulation of derivatives in the EU, has been in force since 2012. However, much of the relevant rule-making under EMIR needs to be introduced by technical standards through delegated legislation. Although this process is well under way, some aspects of EMIR are still in the process of being introduced and this will continue into 2017 and beyond.

One of the central limbs of EMIR is the requirement for mandatory central clearing for derivatives entered into by financial counterparties and certain significant non-financial counterparties (“NFCs+”), subject to ESMA mandating that a particular

class of derivative should be subject to such requirement. From June 2016, Category 1 counterparties (clearing members of at least one EU authorised CCP) have been subject to the obligation in respect of OTC basis swaps and vanilla fixed to floating swaps denominated in euro, pounds sterling, Japanese yen, and U.S. dollars and forward rate agreements and overnight interest swaps denominated in euro, pounds sterling and U.S. dollars. Category 2 counterparties (other financial counterparties or alternative investment funds (“AIFs”) with outstanding trades with a gross notional amount exceeding EUR8bn) will be subject to mandatory clearing in respect of such transactions from 21 December 2016 and Category 3 counterparties (other financial counterparties or AIFs) will be subject to the obligation from 21 June 2017.

In addition, mandatory clearing will apply from 9 February 2017, for Category 1 counterparties in respect of (i) fixed to floating rate interest rate swaps and forward rate agreements denominated in Norwegian krone, Swedish krona and Polish zloty; and (ii) untranchised index CDS referencing the iTraxx Main and iTraxx Crossover indices with a tenor of five years. Category 2 counterparties will be subject to mandatory clearing in respect of such transactions from 9 August 2017 and Category 3 counterparties from 9 February 2018.

The other significant area of development under EMIR during 2016 has been in respect of the margining requirements for OTC derivatives transactions, which are not subject to central clearing. EMIR requires certain counterparties to exchange collateral as a way of reducing counterparty risk exposure. Following a somewhat protracted process, the EU Commission adopted a final draft text of relevant RTS (the “Risk Mitigation RTS”) on 4 October 2016.

The Risk Mitigation RTS primarily affects financial counterparties and NFCs+ that are established in the EU. However, non-EU entities that trade with EU entities that are subject to the margin requirements are likely to be obliged to put collateralisation procedures in place in order to allow their EU-established counterparties to comply with EMIR. The Risk Mitigation RTS require the posting of Initial Margin (“IM”) and Variation Margin (“VM”). Such RTS also set out the eligibility criteria for assets that may be used as collateral, designed to ensure that the collateral is sufficiently liquid, not exposed to excessive credit, market or FX risk and holds its value during times of financial stress.

Collateral collected as IM must be segregated from the other assets of the third party or custodian that is holding it. Counterparties that collect IM are forbidden from re-hypothecating, re-pledging or otherwise re-using the collateral. There are some exemptions from the collateral requirements for transactions below certain financial thresholds and intragroup transactions complying with specified criteria. It is now expected that the Risk Mitigation RTS will come into force around January 2017. However, only the largest market participants (those trading non-centrally cleared derivatives in excess of €3trn in aggregate notional amount) will initially be subject to the rules. By September 2020, all counterparties trading such derivatives in excess of €8bn will be subject to the requirements.

**MiFID II:** MiFID II is the overhaul of the Markets in Financial Instruments Directive (“MiFID”) and comprises a Regulation (“MiFIR”) and a recast Directive. It came into force in August 2014 and was originally due to become effective on 1 January 2017. However, due principally to delays in drafting and finalising a number of the many RTS required to be prepared under MiFID II, legislation was adopted in July 2016 delaying the implementation date of MiFID II for a year until 3 January 2018.

MiFID II will make some fundamental changes to MiFID, including significantly widening the regulatory capture for both financial products and entities within the EU. A number of the proposed changes have particular relevance for structured products, including new product governance rules which will require manufacturers of financial instruments to undertake a product approval process for each product and ensure that each product is designed to meet the needs of an identified target market. Distributors must have arrangements in place to obtain relevant information for products they have not manufactured and to understand the characteristics and identified target market of products they distribute. Rules in relation to inducements now severely limit the circumstances in which firms can pay or be paid fees or commissions by any party other than their client. MiFID II also extends the pre- and post-trade transparency requirements to bonds, structured finance instruments and derivatives traded on a traded venue, although competent authorities can grant waivers in respect of such requirements on specified grounds, including in relation to instruments for which there is not a liquid market.

Many of the relevant technical standards under MiFID II have now been finalised and adopted. Much of the focus during 2017 will be on competent authorities in member states ensuring that they are in a position to ensure compliance with MiFID II from 2018. In the UK, the FCA is currently consulting on the UK implementation of MiFID II, with a deadline for comments of 4 January 2017. The FCA is then expected to publish policy statements on all aspects of MiFID II implementation in the first half of 2017. Member states are required to have transposed MiFID II into national laws by 3 July 2017.

**Prospectus Directive (PD3):** As part of its Capital Markets Union action plan, on 30 November 2015, the European Commission proposed a number of adjustments to the rules governing fundraising on public markets or through offers to the public, in the form of a Regulation (referred to as “PD3”) that will replace the current Prospectus Directive. Proposed amendments include abolishing the existing “wholesale exemption” for debt securities (not listed on a regulated market) with a denomination of €100,000 or more, the creation of a lighter-touch disclosure regime for SMEs, a reduction in the length of prospectus summaries (and a harmonisation of such summaries with the KID required under the PRIIPs Regulation), fast-tracking and simplification for frequent issuers via use of a “Universal Registration Document” (similar to a shelf registration concept) and creation of a single access point for all EU prospectuses, making them more available and accessible for investors. It also contains new provisions relating to risk factors including requiring these to be allocated across two or three categories based on materiality and for the summary to include a summary of the principal risk factors (to be no more than ten). This could give rise to increased liability concerns, particularly in relation to structured products where categorising and limiting risk factors may be challenging.

It was originally expected that the new PD3 Regulation would be finalised during 2016. Progress has, however, been slower than expected. In September 2016, the European Parliament adopted a number of proposed amendments to the Regulation. The process will therefore continue into 2017, but we understand political agreement has now been reached between the EU Commission, the EU Parliament, and the EU Council of Ministers and it is expected that the Regulation will be finalised early in 2017.

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## U.S. Regulatory Agenda: What to Expect in 2017 (for Structured Products)

At the end of each of the last several years, we have shared with readers our list of anticipated areas of focus for the coming year. This particular December, that seems like a harder task than in prior years. With a new administration, which is committed to revisiting regulation, the only thing we can predict with any certainty is that the coming year will bring change.

The new administration will have to make significant appointments that will affect the principal regulatory agencies affecting our markets. Mr. Trump will have the ability to nominate three Commissioners to the Securities and Exchange Commission to work with Commissioner Piwowar, a Republican, and Commissioner Stein, a Democrat. Commissioner Piwowar is expected to be named Chair on an interim basis following current Chair White’s announced departure. Of the three new Commissioners, at least one will be a Democrat. Mr. Trump also will be required to appoint new Commissioners to the Commodity Futures Trading Commission. There are only three Commissioners, Chairman Massad, a Democrat, Commissioner Bowen, also a Democrat, and Commissioner Giancarlo, a Republican. Chairman Massad is expected to tender his resignation prior to the end of President Obama’s term. This means that Mr. Trump will be able to appoint two new Republican Commissioners and one Democrat. Of course, Mr. Trump also will have the ability to fill vacancies at the banking agencies, including naming a Vice Chairman of Supervision at the Federal Reserve. Through the Congressional Review Act, Congress will have the ability in the near-term to review certain major rules, and it is more likely that change will be effected more gradually since many of the measures that have been discussed by the new administration, including a “roll back” of certain Dodd-Frank Act provisions, would require legislation. Finally, as we discuss further below, a change in tone with respect to enforcement ultimately may be the most significant to market participants.

Below, we highlight a number of the key regulations and initiatives affecting the U.S. market that we will be following closely:

**Department of Labor’s fiduciary rule:** Immediately following the presidential election, market participants were quite focused on the potential for a repeal of the Department of Labor’s final fiduciary rule. However, a repeal of the final rule would require the enactment of legislation. The influential Freedom Caucus’ report released last week includes a call for the repeal of the final rule. A repeal would take many months and may not be at the top of the legislative agenda for the new administration. The Department of Labor might instead, as we discuss in a prior issue of the newsletter (see: <https://media2.mofo.com/documents/161213-structured-thoughts.pdf>, page 5), delay the implementation of the rule for some period while rulemaking is considered. With the April 2017 effective date looming and many broker-dealers having already undertaken measures (expected to be rolled out in January 2017) which will allow these entities to transition into full compliance by the effective date, many market participants will not reverse course.

**FINRA's proposed rule on senior investors:** We anticipate the SEC will approve FINRA's recent proposal (see our post: <http://www.bdiaregulator.com/2016/10/finra-proposes-rules-to-protect-seniors-from-financial-exploitation/>) which would, among other things, amend existing customer account information rules and adopt a "safe harbor" for broker-dealers to impose a temporary hold on the accounts of senior investors where they suspect financial exploitation of senior investors. The SEC, FINRA, and state regulators have been focused on "at risk" investors, including senior citizens, for some time and the FINRA proposal was generally well received.

**FINRA's final rule on mark-ups for debt securities:** As we reported in a prior issue of the newsletter (see: <https://media2.mofo.com/documents/161213-structured-thoughts.pdf>, page 4), in November 2016, the SEC approved FINRA's proposed rules amending Rule 2232. FINRA member firms will be required to provide additional pricing information on customer confirmations for non-municipal fixed income transactions if a FINRA member trades as principal with a non-institutional customer in a corporate debt or agency debt security. Subject to certain exceptions, the member firm would be required to disclose the mark-up or mark-down from the prevailing market price for the security on the customer confirmation. Compliance with the rule is expected to require substantial effort by member firms.

**The Federal Reserve Board's final long-term debt, total loss absorbing capacity (TLAC) and clean holding company requirements:** As we discussed earlier in this issue, the structured products market already had planned for the final rules with many U.S. G-SIB issuers having established finance subsidiaries through which they will issue debt securities that would not be considered "eligible" long-term debt. The final rules provide additional clarity regarding the types of debt securities that are considered "structured notes." U.S. G-SIBs will generally need to enter into new indentures and make modifications to other regular issuance documents in order to comply with the disclosure and other requirements of the final rules. However, more extensive planning may be required to be undertaken by foreign banking organizations that are G-SIBs and subject to an IHC requirement.

**The European Commission's proposed amendments to the BRRD MREL provisions and proposed implementation of the Financial Stability Board's final TLAC principles:** As we previously reported (see: <https://media2.mofo.com/documents/161209-shaping-mrel-for-european-banks.pdf>), the European Commission released proposals in November to amend the Bank Recovery and Resolution Directive in order to provide detailed guidance relating to the MREL requirement applicable to European banks, as well as regulations to implement the TLAC requirement for G-SIBs. Under the FSB principles, structured notes (a term that is not defined) are not TLAC eligible. However, under the EC's proposals, principal-protected structured notes should be eligible to count towards a non-G-SIB's MREL and towards any G-SIB's MREL requirements above the MREL floor, in each case to the extent of the principal-protected amount. Foreign bank issuers of structured notes subject to these requirements may undertake a review of their structured note issuance programs in light of these developments. The EC proposals also establish a European IHC requirement for non-European banks that meet certain thresholds, which would include many of the U.S. G-SIBs. As a result, these entities will want to consider their European legal entity structure and funding.

**The T+2 settlement initiative:** This fall, the SEC, FINRA and the NYSE proposed amendments to various regulations, including, in the case of the SEC, Rule 15c6-1 under the Securities Exchange Act of 1934, in order to shorten the transaction settlement cycle from T+3 to T+2. The shortened settlement cycle is intended to reduce credit risk, market risk, liquidity risk, and overall counterparty risk. Market participants are generally supportive of the move to a shortened settlement cycle; however, the change will impose a substantial burden on broker-dealers. Issuers and underwriters of structured notes will seek to identify ways to further streamline their issuance process to account for the change.

**FINRA's cross-selling sweep:** In October, FINRA announced a cross-selling sweep in which it requested information regarding the extent to which member firms were promoting bank products of affiliated or parent companies or other services offered by affiliates (such as securities-based lending arrangements) to retail broker-dealer accounts. See our prior summary: <https://media2.mofo.com/documents/161116-structured-thoughts.pdf>, page 5. Although the sweep was not prompted by any issues arising from structured products, it highlights continued regulatory interest in potential conflicts of interest.

**Conflicts of interest:** The SEC and FINRA remain focused on the manner in which broker-dealers address potential or actual conflicts of interest. As part of its review of conflicts of interest policies, FINRA held meetings with a number of member firms. It is reasonable to expect that, consistent with past practice, FINRA would share general findings from its review and address the types of conflicts of interest policies and practices that it found to be effective in mitigating risks. Any such findings may ultimately become considered "best practices," to the extent that they are adapted by additional market participants.

**Sales to at risk investors:** As noted above, FINRA has proposed rule amendments to address senior investors. Sales of complex products and sales of unsuitable products to at risk investors, including senior investors, other investors on fixed incomes or with a need for near-term liquidity or current income, and to affinity groups, likely will remain a focus of attention for the SEC's Office of Compliance Inspections and Examinations, FINRA, and state regulators.

**Enforcement:** The rumored "roll back" of certain Dodd-Frank Act measures may not necessarily involve the repeal of controversial rules, like the Volcker Rule, and may instead translate into a more relaxed enforcement environment, at least in certain areas, for financial institutions.

**A Culture of Compliance:** Despite a possible change in the overall tone taken by regulators toward financial institutions, it is fair to anticipate that, in light of recent events, regulators and also legislators will remain focused on ensuring that regulated institutions promote a culture of compliance. FINRA's 2016 "sweep letter" relating to broker-dealer culture may be followed by similar steps by other regulators.

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## Upcoming Event

### Brexit: Impact on UK-Based Banks – Earthquake or Tremor?

Wednesday, January 11, 2017

PLI Webinar, 11:00 a.m. – 12:00 p.m. EST

Following the UK's vote in June 2016 to leave the EU, one of the major areas of concern has been the impact of Brexit on the UK banking sector. In addition to UK banks, many international banks headquarter their European activities through branches or subsidiaries based in London. Topics will include the following:

- What is meant by the "single market" for financial services and the "EU passport"?
- "Hard Brexit" vs. "Soft Brexit": What do these terms mean in the context of banking and financial services? To what extent are UK-based banks likely to be able to maintain access to EU markets following Brexit in each scenario?
- When will banks need to make firm decisions about possible relocation of activities to other EU jurisdictions?
- What will be the impact of recent proposed changes to CRD4/CRR and the BRRD to non-EU banks carrying out activities in the EU?
- In its G20 memo, the Japanese government asked for certainty and transparency in the Brexit negotiations. What are the chances?

**Speakers:** Peter Green and Jeremy Jennings-Mares, Morrison & Foerster LLP

To register or for more information, [click here](#).

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### Join Our *Structured Thoughts* LinkedIn Group

Morrison & Foerster has created a LinkedIn group, *Structured Thoughts*. The group serves as a central resource for all things *Structured Thoughts*. We have posted back issues of the newsletter and, from time to time, disseminate news updates through the group.

To join our LinkedIn group, please [click here](#) and request to join, or simply e-mail Carlos Juarez at [cjuarez@mofo.com](mailto:cjuarez@mofo.com).

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Morrison & Foerster has been named Structured Products Firm of the Year, Americas by *Structured Products* magazine seven times in the last 11 years.

Morrison & Foerster was named Best Law Firm in the Americas four out of the last five years by *StructuredRetailProducts.com*.

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