MORRISON | FOERSTER

News Bulletin

January 26, 2012

FINRA Files Amendments to FINRA Rule 5123 on Private Placements

On January 19, 2012, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed a Partial Amendment No. 1 (the "Partial Amendment") to proposed FINRA Rule 5123 (Private Placement of Securities) with the Securities and Exchange Commission (the "SEC")[1] to address concerns raised by market participants. The Partial Amendment would narrow the proposed definition of "private placement" and modify the proposed disclosure and filing requirements in private placements.

Background

FINRA proposed Rule 5123 (the "Proposed Rule") on October 5, 2011.[2] Comments were due on November 18, 2011. The SEC received 16 comment letters in response to the Proposed Rule. On November 17, 2011, FINRA extended the period for the SEC to approve the Proposed Rule to January 20, 2012. The comments expressed a broad range of concerns, including concerns regarding: the scope of the definition of private placement; the broker-dealer disclosure requirements; the filing requirements; the exemptions; and whether the Proposed Rule is consistent with FINRA's regulatory oversight and authority. FINRA responded to the comments in its Response Letter and filed the Partial Amendment to address these concerns.[3]

The Partial Amendment

The Partial Amendment:

- Clarifies that the term "private placement" in the Proposed Rule would mean a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act of 1933, as amended (the "Securities Act"), making it consistent with FINRA Rule 5122. The definition would not apply to securities offered pursuant to:
  - Sections 4(1), 4(3) and 4(4) of the Securities Act;

[1] See Notice of Filing of Partial Amendment No. 1 and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as modified by Partial Amendment No. 1, to Adopt FINRA Rule 5123 (Private Placements of Securities), Exchange Act Release No. 66203 (the "SEC Release") (Jan. 20, 2012), available at http://www.sec.gov/rules/sro/finra/2012/34-66203.pdf.
[2] For a discussion of the evolution and contents of the Proposed Rule, see our client alert available at http://www.mofo.com/files/Uploads/Images/111010-FINRA-Proposes-Rule-5123-in-lieu-of-Proposed-Rule-5122.pdf.
[3] The text of Partial Amendment No. 1 and FINRA's Response Letter are available at http://www.finra.org/Industry/Regulation/RuleFilings/2011/P124600.

- Sections 3(a)(2) (offerings by banks), 3(a)(9) (exchange transactions), 3(a)(10) (securities subject to a fairness hearing), or 3(a)(12) (securities issued by a bank or bank holding company pursuant to reorganization or similar transactions), of the Securities Act; or
- Section 1145 of the Bankruptcy Code (securities issued in a court-approved reorganization plan that are not otherwise entitled to the exemption from registration afforded by Securities Act Section 3(a)(10)).

- Amends the filing and disclosure requirements for those private placements for which a disclosure document includes a description of the anticipated use of offering proceeds, the amount and type of offering expenses and compensation provided or to be provided to sponsors, finders, consultants, and members and their associated persons in connection with the offering. Members would be required to provide, prior to any sale, the disclosure document to each investor other than those investors in a private placement that would be subject to an exemption, as provided by the Proposed Rule, as amended.[4] Each member participating in the offering, or a member designated to make the filing on behalf of all members identified in the filing, would also be required to file such document with FINRA no later than 15 calendar days after the date of first sale.
- Amends the filing and disclosure requirements for those private placements for which there is no disclosure document to eliminate the requirement that members provide investors with the required disclosures. If no disclosure document is used, the participating member (or a designated member acting on behalf of the member) would instead be required to make a notice filing, identifying the private placement and the participating members and stating that no disclosure document was used, with FINRA no later than 15 calendar days after the date of first sale. The Proposed Rule as amended by the Partial Amendment would not prohibit a member from participating in such private placements, and would not require the member to make any additional disclosure to investors in such offerings.
- Clarifies that the Proposed Rule would not require delivery of multiple copies of a disclosure document to a single customer. Specifically, the Proposed Rule would require an affected member to deliver disclosure documents only to persons to whom it sells shares in the private placement.

What's Next?

In light of the issues raised by the Proposed Rule, the SEC determined to institute proceedings pursuant to Section 19(b)(2) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act") to determine whether to approve FINRA's Proposed Rule. In its release, the SEC stated, "Institution of such proceedings appears appropriate at this time in view of the legal and policy issues raised by the proposed rule change."[5] The SEC also stated it believes FINRA's Proposed Rule, as amended by the Partial Amendment, raises questions as to whether it is consistent with the requirements of Section 15A(b)(6) of the Exchange Act. Section 15A(b)(6) requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

It remains uncertain whether the Proposed Rule, as amended by the Partial Amendment, would be approved by the SEC. Comments on the Proposed Rule, as modified by the Partial Amendment, are due 30 days from publication in the Federal Register. In addition to general comments, the SEC specifically seeks comments on the proposed definition of "private placement"; the potential impact on investors purchasing private placement securities through a broker-dealer; the potential impact on members of having to comply with the Proposed Rule; and the potential impact on competition and capital formation, including:

[4] For a description of the exemptions, see our client alert available at http://www.mofo.com/files/Uploads/Images/111010-FINRA-Proposes-Rule-5123-in-lieu-of-Proposed-Rule-5122.pdf.
[5] See SEC Release, available at http://www.sec.gov/rules/sro/finra/2012/34-66203.pdf.

- whether members would continue to participate in private placements subject to the Proposed Rule;
- whether the Proposed Rule would encourage issuers to use unregistered firms to effect their covered offerings; and
- whether the Proposed Rule would affect access to capital, the costs of capital raising or the cost of capital for issuers.

The future evolution of FINRA Rule 5123 will have to await another comment period.

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About Morrison & Foerster

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Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

FINRA Notice Regarding Complex Products

FINRA recently released Regulatory Notice 12-03 titled "Complex Products: Heightened Supervision of Complex Products." The Notice identifies the types of products that may be considered "complex" and provides guidance to member firms regarding supervisory concerns associated with sales of complex products. Until now, in the United States we had avoided the debate ongoing for some time now in Europe regarding "complex" and non complex (simple?) products. It is interesting that FINRA is now headed in a direction similar to that taken by European regulators.

This Notice identifies as complex products those that include "complicated or intricate derivative-like features", like structured notes, certain exchange-traded funds, hedge funds and asset-backed securities. The Notice references FINRA's prior Notices to Members and Regulatory Notices regarding particular types of structured products. The Notice reminds member firms that the firms should review and assess the adequacy of their controls with respect to products that may be deemed complex. In this regard, the Notice reminds members that they must discharge their suitability obligation, which entails diligence regarding the features of the product, including potential risks and rewards. FINRA poses a number of suggested questions that should be considered during the diligence process. The Notice reminds firms that they should establish post-approval review processes in respect of new and complex products. Specialized training also may be appropriate for registered representatives charged with selling complex products. Member firms also should consider the financial sophistication of customers when recommending a complex product and should engage customers in a discussion of product features, risks, rewards and costs. Member firms also should consider whether less complex or costly products would achieve the customer's goals. In sum, many of the same themes have been communicated in prior FINRA releases; however, we note that this Notice appears to be taking the dialogue regarding financial products in a new direction on this side of the Atlantic.

FINRA's Consent Agreement: A Continued Focus on Adequate Supervisory Systems and Procedures in the Sale of Reverse Convertible Notes

Introduction

In December 2011, the Financial Industry Regulatory Authority ("FINRA") announced that it had fined Wells Fargo Investments, LLC $2 million, and required the broker-dealer to pay restitution to investors. These penalties arose from alleged unsuitable sales of reverse convertible securities by a former registered representative affiliated with the company, Alfred Chi Chen, and for failing to provide sales charge discounts on Unit Investment Trust ("UIT") transactions to eligible customers.[1]

Prior to FINRA's announcement, FINRA entered into a Letter of Acceptance, Waiver and Consent with the broker-dealer (the "Consent Agreement").[2] The Consent Agreement sets forth the factors that led to FINRA imposing these penalties.

Some of the actions described in the Consent Agreement were not unique and have been attributed to other institutions,[3] as FINRA has carefully scrutinized in recent years the appropriateness of the sale and suitability of reverse convertible notes and the adequate supervision of employees, particularly those that have offered structured products. We note that FINRA's actions focus on activities that occurred between 2006 and 2009, prior to the time that reverse convertible sales became as highly publicized as they are today, and before many institutions began to more carefully scrutinize their procedures in the area.

1. A Firm Must Establish Adequate Written Supervisory Procedures and an Effective Supervisory System for Sales of Reverse Convertibles

FINRA has emphasized the importance of adequate supervisory systems and written procedures pertaining to reverse convertible sales. One particular focus has been customer suitability. FINRA criticized the broker-dealer, through Chen, for recommending hundreds of unsuitable reverse convertible transactions to customers, most of whom were elderly,[4] and who had conservative investment objectives and limited experience investing in options and in equities.

Accordingly, close attention should be paid to customer profiles and investment history when recommending financial products such as reverse convertibles. Transactions should be approved upon adequate inquiry into the suitability of the purchases and concentrations in the accounts of these customers. FINRA suggests that firms should provide supervisors with reports that demonstrate customer investment concentrations to assist in suitability identification.

In addition, the Consent Agreement focuses on the establishment of protocols pertaining to the sales of reverse convertibles, which must be carefully monitored for compliance. During the relevant period, the broker-dealer implemented a required training program for each registered representative who sold the reverse convertibles.

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[1] A copy of FINRA's press release relating to these actions may be found at: http://www.finra.org/Newsroom/NewsReleases/2011/P125262.

[2] The Consent Agreement may be found at: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p125264.pdf.

[3] See, for example, the [April 2011] UBS consent (the "UBS Consent"), which may be found at: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123478.pdf. Our summary of the UBS Consent may be found in *Structured Thoughts*, Volume 2, Issue 4: http://www.mofo.com/files/Uploads/Images/110414-Structured-Thoughts.pdf. The Santander consent (the "Santander Consent") may be found at: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123490.pdf.

[4] According to FINRA's complaint, except for one exception, all of Mr. Chen's accounts that invested in reverse convertible notes belonged to persons who were at least 65 years old, many of whom were in their 80s and 90s.

However, as there was no system in place to ensure compliance, many registered representatives placed trades without completing the training program.

2. A Firm's Sales Representatives Must be Adequately Supervised

In the Consent Agreement, FINRA emphasized the importance of the reasonable supervision of sales representatives. FINRA criticized the broker-dealer for not investigating the suitability concerns of the reverse convertibles being sold to elderly customers. During the last two years of Chen's employment, he had derived 75% of his total commissions from reverse convertible sales, was the firm-wide top producer of reverse convertible commissions and was promoted to a senior position. To facilitate these transactions, Chen allegedly changed the investment objectives of some customers. These changes were red flags which went without investigation by his supervisors, despite compliance reports showing unreasonable concentrations of reverse convertibles in the accounts that he advised.[5]

3. A Firm Must Establish and Effect Adequate Supervisory Procedures for Sales of Unit Investment Trusts

FINRA criticized the broker-dealer for failing to apply discounts to customers who qualified for breakpoint discounts or rollover or exchange discounts, which resulted in additional sales charges to those customers. The firm had relied upon its sales force and their respective supervisors to monitor accounts for the appropriate discounts, but did not implement a formal procedure to ensure compliance.

In the Consent Agreement, FINRA emphasized the importance of establishing, maintaining and enforcing effective supervisory systems and written supervisory procedures to prevent customers from incurring unnecessary sales charges. These systems and procedures should be designed to ensure that qualified customer accounts receive their proper breakpoint discounts or rollover and exchange discounts.

Conclusion

The circumstances surrounding these alleged violations are particular to the facts described in the Consent Agreement. However, a common theme in many of FINRA's recent decisions relates to the establishment of adequate sales supervisory policies and procedures and ensuring investment suitability. The Consent Agreement demonstrates the need for firms to perform a careful review of their supervisory procedures and systems with respect to sales of structured products. We may not have seen the last of FINRA's investigation of improper sales practices.

FINRA Revises Proposal re Communications with the Public

In July 2011, FINRA proposed to amend several of its rules relating to broker-dealers' communications with the public.[6] These rules relate to a number of areas, and potentially impact a wide variety of securities offerings.[7] In December 2011, FINRA further revised its proposal.[8]

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[5] FINRA's complaint against Mr. Chen (available at: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p125266.pdf) indicates a variety of unauthorized trades by Mr. Chen, including placing orders for securities for the accounts of holders who had passed away, and explicitly contravening a client's request not to make any purchases from her account.

[6] The text of the proposed rules may be found at the following web page: http://www.finra.org/Industry/Regulation/RuleFilings/2011/P123894.

[7] For example, the proposals impact Rule 2210 (Communications with the Public), Rule 2212 (Use of Investment Companies Rankings in Retail Communications), Rule 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings), Rule 2214 (Requirements for the Use of Investment Analysis Tools), Rule 2215 (Communications with the Public Regarding Security Futures), and Rule 2216 (Communications with the Public About Collateralized Mortgage Obligations (CMOs)). We discussed a variety of these provisions in

The December 2011 revisions remove an aspect of the July 2011 proposed rules that had generated significant controversy. Proposed supplementary material ".01" to Rule 2210, proposed in July 2011, would have applied certain FINRA guidance to internal-use only materials. The supplemental material would have provided that a member's internal written communications that are intended to educate or train registered persons about the member's products or services would be considered "institutional communications" under paragraph (a)(3) of FINRA Rule 2210. As a result, these internal communications would have been subject to both the provisions of proposed FINRA Rule 2210 and NASD Rule 3010(d). Among the potential effects would have been a requirement for each member to establish appropriate written procedures for review of these written materials by an appropriately qualified registered principal.

In the December 2011 revisions, FINRA has removed this supplemental material from the proposal, and has also explicitly provided that "institutional communications" do not include internal-use only materials. That being said, caution is still advisable in connection with the preparation and dissemination of internal-use only materials. Prior FINRA investigations have focused upon the adequacy of these types of materials, and whether they were sufficient to properly educate the sales force about the nature and risks of the products that they offered.

FINRA itself takes the position that these types of materials are governed by the supervisory provisions of NASD Rule 3010.

FINRA's proposal is subject to a comment period that will end on January 18, 2012.

SEC Announces Second Extension of Comment Period for Conflict of Interest Rules

In September 2011, the SEC proposed new Rule 127B, which is intended to address the conflicts of interest provisions of Section 621 of the Dodd-Frank Act. Proposed Rule 127B would generally prohibit certain persons involved in the structuring, creation and distribution of an asset-backed security ("ABS") from engaging in certain transactions that would result in a material conflict of interest with respect to any investor in that ABS. We discussed the proposal and its potential impact on structured products in a prior issue of *Structured Thoughts*, which may be accessed at the following link: http://www.mofo.com/files/Uploads/Images/111108-Structured-Thoughts.pdf.

In December 2011, the SEC announced that it would extend the comment period for the proposal until February 13, 2012. The comment period had previously been extended through January 13, 2012. The new extension will provide market participants with additional time to prepare and submit their comments on the proposal.[9] In providing the extensions, the SEC noted that the comment period for the "Volcker Rule Proposal" relating to proprietary trading and other matters will end on February 13, 2012. Accordingly, the SEC believes that the extended comment period will enable market participants to focus on, together with any other comments, the interplay between proposed Rule 127B and the Volcker Rule Proposal, and will benefit the SEC in its preparation of the final rules.

our July 26, 2011 client alert, which is available at: http://www.mofo.com/files/Uploads/Images/110726-FINRA-Proposed-Rules-2210-2211.pdf. In Volume 2, Issue 10 of *Structured Thoughts*, we addressed the potential impact of these rules on the structured products market in particular.

[8] The text of the December 2011 revisions may be found at: http://www.sec.gov/rules/sro/finra/2011/34-66049.pdf.

[9] The SEC's release concerning the extension may be found at the following link: http://www.sec.gov/rules/proposed/2011/34-66058.pdf.

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

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

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News Bulletin

December 28, 2011

ESMA Consultation on Further Prospectus Directive Technical Advice

Fresh from delivering its final technical advice to the European Commission on final terms and summaries in the context of the Prospectus Directive Amending Directive (2010/73/EU),[1] the European Securities and Markets Authority (ESMA) has now turned its focus towards some of the remaining topics on which it has been mandated by the Commission[2] to provide technical advice. On 13 December 2011, ESMA published a Consultation Paper[3] containing its proposed advice in relation to the consent to use a prospectus in a retail cascade, as well as a review of certain provisions of the Prospectus Regulation (809/2004). Once ESMA's technical advice is delivered to the Commission in final form, the Commission will consider it in proposing legislation on the issues which were delegated to it in the Amending Directive.

Consent to Use Prospectus in a Retail Cascade

ESMA's definition of a retail cascade is "a distribution mechanism where securities are offered to retail investors not directly by the issuer, but by a distribution network of financial intermediaries." It considers that this can encompass more than one structure – firstly, a sale from the issuer to the financial intermediaries and a subsequent sale by the intermediaries to the retail investors, and secondly, a placement of the issuer's securities to the retail investors by the intermediaries, without the intermediaries actually acquiring those securities at any point. In both cases, though, the financial intermediaries are acting in association with the issuer.

Nevertheless, from the point of view of the Prospectus Directive (PD), any offer by the intermediaries to the retail investors can constitute an offer of securities to the public, distinct from any offer made by the issuer to the financial intermediaries. The offer by the issuer to the intermediaries would usually be exempt from the requirement to publish a PD-compliant prospectus, but the subsequent offer to retail investors would require the publication of such a prospectus unless (unusually) it fell within one of the PD exemptions.

ESMA's predecessor, CESR, had previously issued guidance to the effect that separate prospectuses were not required where intermediaries were acting with the issuer's authorisation. However, the Amending Directive enshrined for the first time in legislation the concept that a PD-compliant prospectus, published by the securities issuer, could be relied upon by financial intermediaries placing or re-selling the securities, so long as the prospectus remained valid and up-to-date at the time of the placing or re-sale and so long as the issuer consented to the use of the prospectus by such intermediaries for such purpose.

[1] See Morrison & Foerster client alert "ESMA Final Report on Summaries and Final Terms Under the Prospectus Directive," http://www.mofo.com/files/Uploads/Images/111020-ESMA-Final-Report.pdf.
[2] http://ec.europa.eu/internal_market/securities/docs/prospectus/esmaadv_en.pdf.
[3] http://www.esma.europa.eu/system/files/2011-444.pdf.

The Amending Directive requires that such consent is to be contained in a written agreement. In its Mandate, the Commission asked ESMA to advise on the possible format and method of disclosing such an issuer consent to the relevant parties. In particular, ESMA was asked to focus on the duration of the consent, any conditions to be attached, the effect of such consent on the respective liabilities of the issuer and the intermediaries for the prospectus content, and the circumstances in which a resale or final placement of securities can be considered compliant with the written agreement.

Terms of Subsequent Offers/Placements

ESMA considers that the terms of any subsequent offer/placement of securities in a retail cascade must be in accordance with the terms set out in the prospectus published by the issuer, and therefore that the issuer needs to include, in the prospectus, information on the method of determining the price for offers by the intermediaries, and how that pricing will be disclosed. It considers that intermediaries cannot re-sell or place the securities on terms that conflict with those in the prospectus and therefore that any pricing variation, or contractual selling arrangements of the intermediary, contained in the retail placing must not be inconsistent with the methodology set out in the prospectus for determining the price.

The implication of this is that, in circumstances where the terms of a re-sale or final placement conflict with the contents of the issuer's approved prospectus, then any consent provided to the financial intermediary by the issuer would no longer be applicable for such re-sale/placement and the financial intermediary would need to produce its own PD-compliant prospectus.

This approach of ESMA would seem to restrict retail cascades to only a very tightly controlled distribution chain and would be very limiting for future retail issuances.

Duration of Consent/Responsibilities of the Issuer

ESMA is of the view that any consent of the issuer to a financial intermediary cannot extend beyond the validity of the prospectus, and that it remains the issuer's responsibility to keep the prospectus up to date for the whole of the period of consent. A prospectus must, under Article 16 of the Amending Directive, be supplemented to address every significant new factor, material mistake or inaccuracy in the prospectus information, which is capable of affecting the assessment of the securities and which arises after the approval of the prospectus, but before the final closing of the offer to the public or, if later, the commencement of trading of the securities on a regulated market.

In a case where there is no trading on a regulated market, ESMA therefore considers that a prospectus cannot be supplemented after the final closing of the offer to the public and therefore that no consent by the issuer to a financial intermediary to use the prospectus can extend beyond the closing of the offer to the public. It therefore believes that the offer period to be stated in the prospectus, in accordance with Annex V to the Prospectus Regulation, must take into account the dates of the subsequent public offers by the intermediaries who are considered to be part of the retail cascade.

Disclosure Principles Regarding Retail Cascades

ESMA does not consider that the written agreement, containing the consent, needs to be publicly disclosed. However, it has stated that there needs to be a public disclosure of the consent itself, of the identity of the financial intermediaries and of any conditions attached to the consent. Its intention is that the investor will know that the issuer takes responsibility for the prospectus if it knows that the issuer has consented to the intermediary's use of it, but that if there is no consent, the intermediary must publish a new prospectus and be responsible for the information contained in it.

Problems arise here for the issuer in disclosing the identities of the financial intermediaries in circumstances where additional intermediaries are added to the retail cascade after the date of publication of the approved prospectus, or after the date of a final terms document, in the case of a programme offering.

Such issues could potentially be alleviated if the consent, and the identity of the intermediaries and any conditions to the consent, could be published separately from the prospectus/final terms, for instance on the website of the issuer, where it could be kept constantly updated. However, ESMA has concerns regarding the accessibility of information on a website, what language requirements should apply and how it could be proved that a consent had been given previously, when the consent is subsequently removed from the website. It therefore currently takes the view that such publication has to be made in the prospectus or the base prospectus/final terms, as the case may be.

Therefore, ESMA believes that the prospectus or base prospectus/final in relation to a retail cascade terms need to disclose:

- that the issuer will be offering securities through financial intermediaries;
- that the issuer consents to the use of a prospectus by such intermediaries (thereby accepting responsibility for the prospectus contents for the offers by such intermediaries);
- the intermediaries' identities and addresses; and
- any conditions to the consent, including its duration, and proposes the amendment of the relevant Annexes to the Prospectus Regulation to reflect the above principles.

In the context of a base prospectus/final terms structure, ESMA considers that the last two information items, if not known at the time of approval of the base prospectus, can be included in final terms if the base prospectus leaves placeholders for that information.

In the case of an issuance under a programme, using final terms, ESMA considers that where a new intermediary is appointed after the filing of the final terms document, an announcement to the market as to the new intermediary is not sufficient and it expects the issuer to publish and file a "replacement final terms" document each time a new financial intermediary is given consent to use the prospectus for its retail offers.

This approach ignores the fact that a final terms document is a contractual document, as well as a disclosure document, since it is typically incorporated into the terms of the global note itself and therefore would require the consent of the other contracting parties, e.g., the noteholders. It seems likely that noteholders may be somewhat bemused by a request to consent to a change to the final terms which is irrelevant to the ongoing relationship between the issuer and noteholders.

Even if this approach were considered workable for programme issuances, there is no equivalent for "standalone" issuances. Therefore, if ESMA continues to take the view that an announcement to the market is not sufficient, the question arises as to how an issuer under a standalone prospectus can add additional financial intermediaries to the retail cascade after the publication of the prospectus.

Assuming that the appointment would not meet the criteria contained in Article 16 of the Amending Directive (as discussed earlier), and if ESMA seems to accept that such appointment would not be a "significant factor" in this context, then a supplement to the prospectus would not be required. However, if an announcement to the market is not considered sufficient, it is not clear how ESMA proposes that the issuer would communicate to investors that a new consent has been given without a prospectus supplement. This would entail a right for investors to withdraw their acceptances under Article 16 of the Amending Directive, not to mention the cost and delay factor involved in the preparation and approval of the supplement.

Despite being requested by the European Commission to advise on any necessary conditions to a consent, ESMA has declined to do so, taking the view that this is a matter of private contract between the relevant parties, provided that any conditions imposed are published.

Review of Prospectus Regulation Content Requirements

The second part of the Commission's Mandate being considered by ESMA in this Consultation Paper is the request to consider certain provisions of the Prospectus Regulation.

Information on Taxes Withheld at Source

Several Annexes to the Prospectus Regulation require disclosure of information on taxes on income from securities withheld at source. ESMA's predecessor, CESR, in its Frequently Asked Questions publication, had expressed the view that this requirement only extended to amounts to be withheld by the issuer or by its paying agent, so that an investor could know the "net" amount to be received when collecting payment from the issuer or its paying agent.

This interpretation had presumably been decided on by CESR, due to the impossibility of the issuer being able to anticipate and analyse the withholding requirements in respect of custodians and other intermediaries in the payment chain who were not appointed by it. As a result, the European Commission invited ESMA's advice on whether the Prospectus Regulation should be amended to reflect this interpretation.

However, instead of endorsing the European Commission's suggestion in this regard, ESMA has actually rejected CESR's interpretation, citing the reason that some investors have suffered as a result of tax withholdings being made by intermediaries in the payment chain of which the investors were not informed in advance. It considers that the prospectus must disclose sufficient information for investors to know the "net" payments they will actually receive from the securities (whether collected from the issuer, its paying agent or from some custodian or other intermediary appointed by the investor).

However, ESMA does not attempt to express any thoughts as to how an issuer could possibly begin to comply with such an obligation, given the variations involved in the jurisdictions and custody structures through which the investors might hold their securities.

Proprietary Indices

Under Annex XII of the Prospectus Regulation, where a security is linked to the performance of an underlying index, the level of required disclosure varies depending on the nature of the index. If the index is composed by the issuer, a description of the index and how it is compiled is required in the prospectus. If it is composed by an entity other than the issuer, then the prospectus only needs to specify where information on the index can be found.

The European Commission has asked ESMA to advise on the effects of allowing the less prescriptive disclosure standard to apply in respect of all index-linked securities, whether or not the underlying index is composed by the issuer. However, ESMA has concluded that a full index description should continue to be required for a proprietary index and that such requirement should also be extended to cover a circumstance where the index is not composed by the issuer but is composed by an issuer group entity or an entity acting in association with the issuer.

Profit Forecasts

Under various Annexes of the Prospectus Regulation, where profit forecasts or estimates are contained in a prospectus, they are required to be accompanied by an accountant's report confirming that the forecast or estimate has been compiled properly and on an accounting basis consistent with the issuer's accounting policies.

ESMA was requested to advise the Commission on whether the requirement for the accountant's report should be repealed on the basis that market announcements are usually issued in advance of the relevant financial results being published.

ESMA concluded that the requirement for such a report should remain, since it believes that accountants play a role in advising the issuer on what assumptions should be made for the forecast/estimate and how the disclosure of such assumptions should be worded in the prospectus. However, it expressed the view that "preliminary statements" should be treated differently from profit forecasts and estimates because preliminary statements are generally expected to be final figures and are not based on underlying assumptions.

It has therefore proposed, in paragraph 21 of the Consultation Paper, a definition of the criteria that information should fulfil in order to be classified as a preliminary statement (such as being an advance statement of the previous financial year's figures, and not being based on any underlying assumptions) and therefore not to be categorised as a profit forecast or estimate.

Audited Historical Financial Information

ESMA was also asked by the Commission to consider whether, for issuances of shares and depository receipts, the current three financial years' account requirements of the Prospective Regulation should be relaxed to two financial years' accounts, except in the case of initial public offerings.

Such a relaxation would make the financial statements requirement consistent with that for debt securities and for securities issued by small and medium enterprises, and it would also render such requirement less stringent than the disclosure standards issued by the International Organization for Securities Commissions. For all of these reasons, ESMA concluded that such a relaxation would not be appropriate.

Next Steps

ESMA has agreed with the European Commission that its technical advice on these parts of the Mandate will be delivered by 29 February 2012 and therefore has set only a short consultation period and requested comments on this Consultation Paper to be received by 6 January 2012.

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Morrison & Foerster News Bulletin Volume 2, Issue 16 December 15, 2011

Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Proposed Amendments to OCC Regulations May Affect Structured Bank Notes

In November 2011, the U.S. Office of the Comptroller of the Currency (the "OCC") proposed amendments to Part 16.6 of its securities offering rules. These rules govern the exemption from OCC registration of certain types of offerings of bank notes. The proposed rules are designed to remove the references to credit ratings in Part 16.6. The proposed amendments may be found at the following link: http://www.occ.treas.gov/news-issuances/news-releases/2011/nr-occ-2011-140a.pdf.[1]

Bank notes enjoy an exemption from registration under Section 3(a)(2) of the Securities Act of 1933 (the "Securities Act"). However, national banks and U.S. federal branches and agencies of non-U.S. banks are subject instead to the OCC's registration rules, which require OCC registration of bank note offerings unless an exemption is available. A widely used exemption from OCC registration is Part 16.6, which is applicable for offerings of non-convertible investment grade debt.[2]

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[1] In addition to the proposed rule amendments relating to the securities offering rules, the proposed amendments also address the rules governing whether a proposed purchase of a security by a bank is permissible. The OCC is also seeking comment on proposed guidance that helps explain the due diligence that national banks and federal savings associations should conduct in purchasing investment securities for their investment portfolios, and to reiterative supervisory expectations for the securities that are in fact purchased.

[2] The current version of Part 16.6 can be found at the website of the U.S. government printing office, using the following link: http://www.gpo.gov/fdsys/pkg/CFR-2011-title12-vol1/xml/CFR-2011-title12-vol1-part16.xml.

Part 16.6 is sometimes used for structured notes issued by bank note issuers; however, its usefulness for these types of issuances is somewhat limited by its requirements of (a) $250,000 minimum denominations and (b) “accredited investor” requirement for investors.

The proposed revision to Part 16.6 arises from Section 939A of the Dodd-Frank Act, which requires federal agencies to review, and potentially remove, references to credit ratings from their rules. The proposed amendments would replace the “investment grade rating” condition of Part 16.6 with a new condition that the notes must be “investment grade.” This new “investment grade” test would not require a specific rating for the relevant notes. Rather, this condition would be satisfied if “the issuer of a security has adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected.” This test appears to be somewhat subjective in nature, and does not provide specific parameters for making this determination. See our complete alert here: http://www.mofo.com/files/Uploads/Images/111206-OCC-Proposed-Regulations.pdf.

Taxation of Financial Instruments

On December 7, 2011, the House Ways and Means Committee and the Senate Finance Committee held a joint hearing on the taxation of financial instruments. During the hearing, the participants focused on the taxation of various derivatives. Interestingly, one of the participants discussed structured products and advocated an approach pursuant to which taxpayers would report mark to market gains as ordinary income or losses. This process would adversely affect a number of structured products. The hearing followed the publication of the Joint Committee on Taxation report, which also discussed the tax treatment of derivatives. The Joint Committee on Taxation report is available here: http://www.jct.gov/publications.html?func=startdown&id=4372. In September 2011, the GAO published its own report, “Financial Derivatives: Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse.” The GAO report is available here: http://www.gao.gov/new.items/d11750.pdf. Both the Joint Committee on Taxation report and the GAO report discuss the taxation of ETNs and note that the tax treatment for ETNs differs from the tax treatment accorded to similar investments. Although this is not the first time that this issue has been raised, it had not been a high priority during the financial crisis when other issues took precedence.

FINRA Sweep Letter on Spread Products

In November 2011, FINRA sent out a sweep letter (the letter is available here: http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters/P125200) to FINRA members seeking information (including advertisements, sales and marketing materials, institutional sales materials, and educational materials) relating to spread-based structured products transactions. Although FINRA did not identify the types of products that it characterized as “spread-based” structured products, presumably these would include range accrual notes and other rate-linked products. The request is consistent in scope with other similar FINRA requests relating to structured products. The request does ask for a description to be furnished that discusses the suitability determination process, as well as training and educational materials. We anticipate that FINRA may issue guidance relating to these products after it has had an opportunity to review the materials submitted in response to the request, which were due by December 7, 2011.

Circuit Breaker Proposals

As part of the continuing regulatory response to the May Flash Crash and continuing market volatility concerns, FINRA and the exchanges announced proposals to revise market wide circuit breakers. The market wide circuit breaker proposals are just one of a number of actions taken by the SEC to prevent recurrence of another flash crash type event. Imposition of a circuit breaker would halt trading in all exchange-listed securities on U.S. markets. The proposed changes would reduce the market decline percentage thresholds that are necessary to trigger a circuit breaker; shorten the length of the trading halt; simplify the structure of the circuit breaker; and use the S&P 500 index (instead of the Dow Jones Industrial Average) as the reference for measuring a market decline. A number of commentators supported the circuit breaker proposals. SIFMA suggested that perhaps the triggering of a specified percentage of single stock circuit breakers should trigger a market wide circuit breaker. SIFMA also urged coordination of the market wide circuit breaker rules applicable to the equity markets with the circuit breaker measures applicable to the options exchanges, as well as with trading halts in the futures markets. The SEC has designated a longer period on which to take action on the circuit breaker proposals, extending the date until December 30, 2011.

ISDA/SIFMA Challenge Position Limits

On December 2, 2011, ISDA and SIFMA jointly filed a lawsuit in the U.S. District Court for the District of Columbia against the CFTC and a petition for review in the U.S. Court of Appeals for the District of Columbia challenging the position limit rules. Among other things, the lawsuit alleges that the CFTC did not satisfy the requirements in the Dodd-Frank Act that it exercise its discretion and determine whether position limits were necessary and appropriate before adopting the rule. The complaint argues that the CFTC failed to present a reasoned analysis and did not consider all evidence in setting position limits. The complaint also notes that the CFTC did not conduct an adequate cost-benefit analysis. The trade associations request that the courts vacate and set aside the position limits.

SEC Extends Comment Period for Conflict of Interest Rules

In September 2011, the SEC proposed new Rule 127B, which is intended to address the conflicts of interest provisions of Section 621 of the Dodd-Frank Act. Proposed Rule 127B would generally prohibit certain persons involved in the structuring, creation and distribution of an asset-backed security ("ABS") from engaging in certain transactions that would result in a material conflict of interest with respect to any investor in that ABS. We discussed the proposal, and its potential impact on structured products, in a prior issue of *Structured Thoughts*, which may be accessed at the following link: http://www.mofo.com/files/Uploads/Images/111108-Structured-Thoughts.pdf.

On December 13, 2011, the SEC announced that it would extend the comment period for the proposal until January 13, 2012. The extension will provide market participants with additional time to prepare and submit their comments.[3] In providing the extension, the SEC noted that the comment period for the "Volcker Rule Proposal" relating to proprietary trading and other matters will end on January 13, 2012. Accordingly, the SEC believes that the extended comment period will enable market participants to focus on, together with any other comments, the interplay between proposed Rule 127B and the Volcker proposal.

[3] The SEC's release concerning the extension may be found at the following link: http://www.sec.gov/rules/proposed/2011/34-65942.pdf.

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

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Morrison & Foerster News Bulletin Volume 2, Issue 15 December 5, 2011

Structured Thoughts

News for the financial services community.

Structured Products Guidance from the FSA

We have previously discussed[1] the "sea change" in the way retail financial products will be regulated by the FSA (and, later on, by its successor, the Financial Conduct Authority) in the UK, as highlighted in the FSA's Discussion Paper[2] published in January 2011 and the "next steps" proposed in its Feedback Statement[3] published in June 2011. The FSA's focus on greater intervention at an earlier stage of the structured product life-cycle is again in evidence in a recent guidance consultation published in November 2011 (the "Consultation").[4]

The Consultation sets out the FSA's proposed guidance to product providers on their internal systems and controls relating to the development, design, marketing and distribution of structured products. In particular, it focuses on ensuring that such systems are adequate, in the context of what it sees as the increasing popularity and complexity of structured products, to minimise the risk of poorly-designed products and mis-selling, or mis-buying,

[1] See client alert, FSA Product Intervention dated March 14, 2011, http://www.mofo.com/files/Uploads/Images/110314-FSA-Product-Intervention.pdf; and client alert, Product Intervention in the UK and the New FCA dated July 5, 2011, http://www.mofo.com/files/Uploads/Images/110705-Product-Intervention-in-the-UK-and-the-New-FCA.pdf.
[2] FSA discussion paper (DP11/1): Product Intervention (25 January 2011), http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf.
[3] FSA feedback statement (FS11/3): Product Intervention (June 2011), http://www.fsa.gov.uk/pubs/discussion/fs11_03.pdf.
[4] FSA Guidance Consultation: Retail Product Development and Governance – Structured Products Review (November 2011), http://www.fsa.gov.uk/pubs/guidance/gc11_27.pdf.

further down the production/distribution chain. The focus of the Consultation is on the ways in which structured investment products (both principal protected and non-principal protected) and structured deposits (together, “structured products”) are designed and marketed to meet the needs of target customers, as well as the post-sales responsibilities of firms (although the FSA states that its focus, in this particular case, is on product providers rather than distributors).

We have summarised below the FSA’s proposed guidance and “actions” to be taken by firms, divided into eight areas. We have also separately summarised its proposed guidance on the application of the Unfair Terms in Consumer Contracts Regulations 1999 (“UTCCR”) to structured products.

Product Approval Procedures

The FSA expects firms to have “*transparent and auditable*” product approval processes which provide for clear roles and responsibilities for the individuals involved in the approval processes, and the processes should “*embed the delivery of fair outcomes for customers.*” The FSA also expects firms to have strict criteria for when a “light touch” approval process may be used and when the full, robust approval process should be required. Firms are advised to put in place a review mechanism to prevent “product creep,” where small changes to a product are made gradually over time, each time under a “light touch” approval process, resulting in an aggregate substantial product change which has not been subjected to the full approval process. It also expects that the process will incorporate effective opportunities for scrutiny and challenge, and that the process itself will be reviewed regularly and updated as necessary.

Product Development

In the context of the product’s development, the FSA highlights the importance of identifying the relevant target market, particularly in relation to identifying customer needs and objectives and designing the product to cater for them. In this regard, consumer research should be specifically designed to help assess the risk profile of the target market, such as their willingness and ability to bear loss and their possible recourse to compensation, such as the Financial Services Compensation Scheme (the “FSCS”). It should also be designed to help assess the investment objectives of the target market, such as whether they are looking for capital growth or return, and their attitude towards risk measured against reward. The FSA considers that firms should analyse the financial knowledge and experience of the target market and their financial background such as tax status and closeness to retirement. For advised sales of structured products, this analysis will not detract from the investment adviser’s responsibility to firstly understand the risks of the product and secondly make a suitable recommendation to the client.

The FSA also considers that changes in financial markets may mean that once-suitable products may later cease to be suitable for their target market, and encourages firms to consider such changes not only in the context of designing new products, but also in the context of considering their post-sales responsibilities (see below) to existing product-holders.

Design and Development of Product Features

The FSA considers that firms should ensure that product features which are visible to consumers are likely to be understandable by them so that they can see where their return is designed to come from, can assess the likelihood of receiving it and, where applicable, can understand that they may receive no return at all, or may lose capital. The FSA states that the design process should take account of factors such as how the gross returns of the product are divided up between the different stakeholders and whether the division (including fees and charges) is “fair” from the consumer’s perspective, as well as possible recourse to the FSCS (or another EU guarantee scheme), the distribution channel (in particular whether advice will be provided) and the tax consequences of the product’s pay-off profile.

The FSA suggests that firms need to be particularly careful concerning the ability of consumers to understand these factors in the case of linked product offerings where the purchase of one product (typically a deposit) is dependent on another (typically a structured product). For structured investment products, the FSA believes that firms should undertake sufficient due diligence in relation to the counterparty (e.g., the securities issuer), such as examining credit default swap spreads and other market information, rather than simply relying on its external credit rating.

The FSA also wants the choice of underlying assets or indices for a product to be driven primarily by consumer needs and not, for example, to match against other assets or liabilities on the counterparty's balance sheet. As with the product approval process, the FSA expects product design frameworks to incorporate procedures for periodic challenge and updating.

The FSA also states that the terms of consumer contracts for structured products should be clear and fair, and accurately represent the features of the product as designed, and it sets out in Annex 2 of the Consultation its guidance in relation to contractual terms to be considered in the design process.

Stress-Testing and Modeling

The FSA recommends that firms should routinely stress-test products for a variety of conditions – both in a situation of a product performing within its design parameters and in a case of the failure of a design feature. It expects stress tests should be robust, including allowing for challenge procedures, transparent and should be built into the product approval process, although they need not always be used, for example in the repeated issuance of a previous product.

In Annex 1 to the Consultation the FSA sets out its guidance for firms in relation to the technical aspects of stress tests, stating that stress tests should be forward-looking as well as involve back-testing, and that simulations should be carried out from the investor's point of view to understand the expected profitability of the product, grading different potential outcomes in terms of probability. The FSA warns against focusing such simulations excessively on asset classes and indices that have generated high recent returns, and so are more marketable. Separately, the FSA sets out in Annex 1 its recommendations for a firm's collateral management processes for structured investment products, including as to the liquidity and asset concentration of collateral and the extent of collateral segregation.

Marketing – Distribution and Communications

Firms are expected by the FSA to take care in the use of non-advised sales of products containing complex features which are difficult to explain, and in deciding the needs of the end-customer, firms should consider the retail customer at the end of the supply chain rather than just the distributors.

However, firms are expected to carry out due diligence on distributors, both initially and on an ongoing basis, including ensuring that products are in fact being sold to their target market. They are also expected to act on their assessments of distributors, as necessary, which action could include amending the product literature for future distribution, providing further training for distributors or limiting distribution to specific channels.

Information to Distributors

The FSA expects distributors to be given sufficient information on the structure of a product, its implicit charges and the market conditions needed to generate a particular outcome so that they can:

- understand the details of the product and its target audience;
- compare the product with other available retail products;

- understand the risk and reward aspects of a product and the cost-benefit analysis of capital protection; and
- understand all the conditions in which the product will perform as expected.

The FSA strongly encourages the use of training for the purpose of informing distributors appropriately. Once the likely training needs of the distributors have been appropriately identified, the training should be targeted to allow them to perform their functions to the consumer as effectively as possible.

Information to Consumers

The FSA urges firms to take action to ensure that information supplied to consumers is clear and is provided before, during and after the point of sale. Firms are expected to assess the nature and complexity of a product and the financial capability of the target market, and tailor the information accordingly. The information should promote the product features in a fair and balanced way, including giving a balanced view of the prospects of receiving maximum returns if returns are being promoted. The possibilities of less than maximum returns or no return at all must be clearly set out.

For structured deposits, the annual equivalent rate should be clearly set out, no less prominently than the minimum and maximum returns of the product.

Post-Sales Responsibilities

One of the stated aims of the FSA is to facilitate the ability of consumers to "*change product, switch provider, submit a claim or make a complaint*" after a sale has completed. Firms are expected to periodically review their products in order to ensure that they still meet the needs of the target audience, and ascertain whether they are on course for the performance originally expected. They are also expected to be able to communicate clearly the basis upon which such assessments are made.

Firms are also urged to develop a strategy to be followed to contact consumers if the performance of a product begins to deviate substantially from what consumers had been led to expect. The FSA also emphasises the importance of firms' responsibility to treat consumers fairly throughout the life of a product and provide for easy methods of early redemption. They are also expected to provide support and assistance to consumers and distributors throughout the life of the product, and where such tasks are outsourced to third parties, they need to perform adequate due diligence on those parties and keep their performance under review.

Contractual Terms and the Application of UTCCR

In its review, the FSA also identified a number of structured product terms that could potentially breach UTCCR. These regulations protect consumers from terms that are considered "unfair," by making them unenforceable against the consumer. The FSA, as a "qualifying body" under the UTCCR, is able to challenge these terms under the scope of the regulations.

The FSA focused its review on identifying those terms, which were not in good faith and caused significant imbalance in the respective positions of the parties[5] or were not written in plain and intelligible language.[6]

The review focused on three types of terms used by firms in their structured products.

[5] Contrary to Regulation 5 of the UTCCR.
[6] Contrary to Regulation 7 of the UTCCR.

Exit Terms

These are terms which either:

- require a consumer to pay a fee to exit the contract early; or
- provide that, on exit by a consumer, the firm would sell the underlying securities in the structured product and refund the proceeds of the consumer's investments.

While the FSA appreciates that fluctuations in the market can make it difficult for firms to specify the exact charges applicable, it has suggested that the firm should at least inform the consumer clearly of the methods for calculating the charges, relating to each different exit circumstance. Additionally these terms should be made easy to locate in the contract, preferably contained in one clear, defined section.

Termination Terms

The FSA reminded firms of the need for the exercise of any termination right by the firm to be a proportionate response, in view of the materiality of the consumer's breach.

Variation Terms

The FSA referred firms to its Statement of Good Practice, in relation to the drafting of variation terms.[7] It drew particular attention to the importance of specifying in the contract a valid reason for any variation of the contract, and reminded firms that in order to comply with UTCCR, firms may have to go further still, including possibly providing notice to consumers that a change has been, or will be, made.

Brochures Accompanying Terms and Conditions

The FSA was additionally concerned about the use of brochures to accompany the terms and conditions of structured products, in particular the growing trend of referencing these brochures in the terms and conditions to point out more detailed information about the product. The FSA has raised two issues about the use of these brochures, citing that any reference or link to the brochure must be clear and easily accessible, as well as warning that this use of the brochures may render all or part of the information contained in them assessable for fairness under UTCCR.

Next Steps

The consultation period ends on 11 January 2012 and the FSA has invited feedback on its proposed guidance for each of the eight areas listed above. In the meantime, the FSA encourages firms to consider the guidance in the Consultation and to compare their own governance procedures against such guidance.

[7] FSA Statement of Good Practice: Fairness of terms in consumer contracts, May 2005, http://www.fsa.gov.uk/pubs/other/good_practice.pdf.

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Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Conflicts of Interest

On September 19, 2011, the Securities and Exchange Commission ("SEC") released a proposed rule ("Proposed Rule 127B") implementing the conflicts of interest provisions of Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). Section 621 added a new section 27B to the Securities Act of 1933, as amended (the "Securities Act"). Proposed Rule 127B was released on September 19, 2011, for a 90-day comment period, which will end on December 19, 2011.

As required by new section 27B of the Securities Act, Proposed Rule 127B would generally prohibit certain persons involved in the structuring, creation and distribution of an asset-backed security ("ABS") from engaging in transactions within one year after the date of the first closing of the sale of such ABS that would involve or result in a material conflict of interest with respect to any investor in such ABS.

The term "asset-backed security" is defined in Section 3(a)(77) of the Exchange Act as "a fixed income or other security collateralized by any type of self liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including – (i) a collateralized mortgage obligation, (ii) a collateralized debt obligation, (iii) a collateralized bond obligation, (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the [SEC] by rule determines to be an asset-backed security for purposes of this section." Section 3(a)(77) of the Exchange Act provides that the term asset-backed security "does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company." Although Section 621 of Dodd-Frank was drafted to address principally structured credit and securitized products, the proposed rule relies on the existing Exchange Act definition of "asset-backed security," which may include within its scope structured products that rely on the use of a special purpose vehicle, or a collateralized product. We anticipate that during the comment process the unintended consequences resulting from reliance on the asset-backed securities definition will become clear. For more on the conflicts provision, please see our alert at http://www.mofo.com/files/Uploads/Images/110929-SEC-Proposes-Dodd-Frank-Conflicts-of-Interest-Rules.pdf.

Volcker Rule

Ever since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010,[1] banking organizations (and some nonbank financial institutions) have attempted to determine the breadth and impact of the Volcker Rule. This rule, now section 13 of the Bank Holding Company Act,[2] generally prohibits a covered banking entity ("CBE")[3] from proprietary trading and from investing in or controlling private equity or hedge funds. Long-awaited guidance is now at hand. Earlier this week, the Federal Reserve Board ("FRB"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC") and the Securities and Exchange Commission ("SEC") (collectively, the "Agencies") all approved a proposed regulation (the "Proposed Rule") for publication.[4] The Commodities Futures Trading Commission ("CFTC") is expected to release its own proposal to implement the Volcker Rule in the near future.

The Proposed Rule sweeps more broadly than the Volcker Rule requires, but provides some greater specificity on certain provisions of the Dodd-Frank Act. The Proposed Rule could have a severe impact on trading or fund ownership or control by banking institutions and others. In a very general sense, the Proposed Rule purports to accommodate trading or fund sponsorships for the benefit of, and where the underlying risks are borne by, customers. If any of these activities are not "for" customers—or if a CBE is unable to demonstrate this fact—then the activity is forbidden. Permitted activities are subject to an array of restrictions and compliance requirements.

Of course, the Rule does not address structured products specifically. However, market participants should focus on the effect of the Volcker Rule on the hedging transactions related to structured products, as well as on the effect on market-making activities for structured products. See our alert on the Volcker Rule at http://www.mofo.com/files/Uploads/Images/111014-Volcker-Rule.pdf, and our outline of considerations for derivatives dealers at http://www.mofo.com/files/Uploads/Images/Discussion-Outline-for-the-Proposed-Volcker-Rule-Proprietary-Trading-and-Derivatives.pdf.

[1] Pub. L. No. 111-203, § 619, 12 Stat. 1376, 1620 (July 21, 2010) ("Dodd-Frank" or the "Act").
[2] 12 U.S.C. § 1851. This provision is Section 619 in Dodd-Frank. We refer herein to Section 13 of the Bank Holding Company Act as the "Volcker Rule."
[3] A CBE is an insured depository institution, its holding company, and any affiliate. Nonbank financial institutions also would become subject to the capital and certain other requirements if and when the Financial Stability Oversight Council ("FSOC") designates them as systemically important. However, the Volcker Rule does not apply the prohibitions on proprietary trading and certain private equity and hedge fund activity to these institutions. These designations may be a while in coming; the FSOC has just begun the rulemaking process for designation. The FSOC proposal for the process is available at http://www.treasury.gov/initiatives/fsoc/Documents/Nonbank%20Designation%20NPR%20-%20Final%20with%20web%20disclaimer.pdf.
[4] The Proposed Rule is available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20111011a1.pdf.

SEC's Staff Legal Bulletin on Legal Opinions

On October 14, 2011, the SEC staff published a legal bulletin (No. 19) that provides guidance on the legality and tax opinions (5.1 and 8.1 exhibits) filed in connection with securities offerings. The legal bulletin memorializes the views taken by the staff in connection with the staff's review of filings. A number of these issues also were raised by the staff with respect to 5.1 legality opinions in connection with offerings of structured products and were discussed in a prior issue of *Structured Thoughts* available at http://www.mofo.com/files/Uploads/Images/110602-Structured-Thoughts.pdf.

As a general matter, a legality opinion must be filed as an exhibit to the issuer's registration statement before it becomes effective, and the opinion cannot be subject to any unacceptable qualifications, conditions or assumptions. The staff legal bulletin confirms that the SEC permits qualified "forward-looking" MTN opinions to be filed at the time of effectiveness of a registration statement, followed by an unqualified opinion either filed at the time of each takedown or included in the text of each pricing supplement related to a specific issuance of notes. The bulletin also addresses the filing of 8.1 tax opinions under certain circumstances, including in connection with registered offerings where "the tax consequences are material to an investor and a representation as to tax consequences is set forth in the filing." Either legal counsel or an independent public or certified accountant can give such an opinion supporting the tax matters and consequences to shareholders described in the filing. A revenue ruling from the IRS also will satisfy this requirement.

Focus on ETFs/ETNs

Since our alert in June 2011 (see http://www.mofo.com/files/Uploads/Images/110607-Structured-Thoughts.pdf) concerning the regulatory scrutiny focused on ETFs, the focus has only intensified. In Europe, a number of regulators have continued to look closely at ETFs. In July 2011, ESMA, the European Securities and Markets Authority, published a discussion paper addressing regulatory and policy guidelines for ETFs and other packaged products. European regulators have focused on concerns related to the complexity of certain of these products, as well as related suitability issues. Many have focused on the use of derivatives or commodities futures by ETFs. Others have focused on market structure or systemic issues that may result from the growth of this market and the development in Europe of the synthetic ETF market. Many of the discussions of ETFs refer more broadly to exchange-traded products and create some potential confusion for investors in distinguishing between ETFs and ETNs. In the United States, there have been a number of Congressional hearings to address market structure issues, and several of these have touched on ETFs. In mid-October, Eileen Rominger, Director of the Division of Investment Management at the SEC, provided testimony on ETFs. Rominger distinguished ETFs from ETNs and helpfully noted the differences as follows:

> Exchange traded notes or "ETNs," which, unlike interests in ETFs, generally are unsecured debt securities issued by public companies, in most cases by bank holding companies or investment banks. ETNs also are exchange-traded securities that can provide the investor with investment exposure to certain market benchmarks or strategies. As ETNs are debt obligations of the issuer of the security, the ETN does not provide the investor with any ownership interest in the referenced security or securities in the referenced index. In addition, an investor in an ETN is exposed both to the market risk of the linked securities or index of securities and the credit risk of the issuer. ETNs do not share the same fund-like or trust-like structure as do other ETPs, and are not registered or regulated as investment companies under the 1940 Act.

However, other participants in the Congressional hearings referred more generally to "exchange-traded products" and seemed to lump ETNs in with ETFs, despite the important differences between these products—especially when considered in light of their impact on trading. We will continue to provide regular updates as regulators move from discussion papers to regulatory action.

Revised FINRA Proposal Applies Content Standards of Rule 2210 to Broadly Disseminated FWPs

On October 31, 2011, FINRA filed a partial amendment to its previous proposals to amend Rule 2210 and Rule 2211, which relate to communications by broker-dealers.[5] The text of the newly proposed amendments may be found at the following link:
http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p125035.pdf.

Among other proposed changes to the previous proposal, the new partial amendment would clarify that broadly-disseminated underwriter free-writing prospectuses will be subject to the content standards of paragraph (d) of proposed FINRA Rule 2210.[6] In contrast, documents such as prospectuses and preliminary prospectuses would remain "issuer documents," to which FINRA would not apply these content standards.

Most broker-dealers currently prepare these documents in an effort to comply with both the guidance of the SEC (and potential liability for misstatements under the securities laws), as well as FINRA's guidance. Accordingly, this aspect of the proposed amendment may not dramatically affect the preparation of these documents. However, the partial amendment reflects FINRA's continuing concerns about the adequacy of free-writing prospectuses that are provided to retail investors, and the possibility that FINRA will continue to review these documents.

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[5] For a discussion of the potential impact of these proposals on offerings of structured products, please see the July 27, 2011 issue of Structured Thoughts (http://www.mofo.com/files/Uploads/Images/110727-Structured-Thoughts.pdf).
[6] The content standards require communications, among other things, to be based on principles of fair dealing and good faith, to be fair and balanced, and to provide a sound basis for evaluating the facts in regard to any particular security or service. FINRA's proposals, as set forth in the link above, would also apply additional content standards.

News Bulletin

October 31, 2011

Higher, Wider, Deeper: EU Commission Publishes MiFID II and MiFIR Proposals

Background

On 20 October 2011, the EU Commission (the "Commission") published its long awaited legislative proposals[1] for the recasting of the Markets in Financial Instruments Directive ("MiFID").[2] The Commission had previously published a consultation paper in relation to its proposals on 8 December 2010.[3] Although many respondents raised a number of fundamental concerns on various aspects of the Commission's proposals during the consultation, most of the major changes proposed in the consultation paper have been retained in a similar form in the draft legislation.

MiFID came into force less than four years ago in November 2007 and made significant changes to the regulatory framework of financial services within the EU, introducing a harmonised regime for the regulation of investment services. Although the EU Commission had indicated it would undertake an early review of MiFID and its effect on the financial markets, the onset of the financial crisis has resulted in a much more far-reaching overhaul of the Directive than was originally contemplated. As highlighted below, the new proposals will significantly expand the scope of MiFID in a number of important respects and will facilitate a more interventionist approach on the part of national regulators and the new European Securities and Markets Authority ("ESMA"). The proposals are intended to tie in with other recent international developments in the regulation of financial markets including the Dodd-Frank legislation in the U.S., the EU Commission's proposals to recast the Market Abuse Directive ("MAD"), which were also published on 20 October 2011, the draft European Markets Infrastructure Regulation ("EMIR"), and the EU Commission's proposals in relation to packaged retail investment products ("PRIPs").

As had been widely expected, the draft legislation is split into two separate documents. Provisions dealing with pre- and post-trade transparency, exchange trading of derivatives, product intervention by national authorities and provision of certain services without a branch by non-EU firms are contained in a regulation ("MiFIR") that will have direct effect in member states without the ability for member states to put their own interpretation on the provisions in implementing legislation. The remaining provisions dealing with matters such as authorisation and operating conditions for investment firms, passporting of activities across the EU, conduct of business rules, including investor protection, and powers of national authorities and ESMA are contained in a directive ("MiFID II") that will need to be implemented by member states through national legislation.

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[1] Draft regulation, http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_652_en.pdf; draft directive, http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_656_en.pdf.

[2] Directive 2004/39/EC of 21 April 2004 on markets in financial instruments, http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l_145/l_14520040430en00010044.pdf, Directive 2006/73/EC of 10 August 2006.

[3] EU Commission public consultation: Review of the Markets in Financial Instruments Directive (MiFID), http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf. See also our client alert: "European Commission Consultation on the Review of MiFID," http://www.mofo.com/files/Uploads/Images/101221-European-Commission-Consultation-on-the-Review-of-MiFID.pdf.

In putting together the draft legislation and previous consultation paper, the EU Commission received technical advice on a number of issues by the Committee of European Securities Regulators ("CESR"), which has now been superseded by ESMA. The legislative proposals do, however, go further than CESR's advice in a number of areas, including the proposals for pre- and post-trade transparency.

We have set out below, the principal features of the draft legislation together with some thoughts as to their potential impact on the operation of financial markets.

Introduction of Concept of Organised Trading Facility

A number of the existing MiFID provisions, particularly in relation to transaction reporting and pre- and post-trade transparency requirements, currently apply only to financial instruments admitted to trading on regulated markets, multilateral trading facilities ("MTFs") and systematic internalisers ("SIs," being investment firms which on an organised, frequent and systematic basis deal on own account outside a regulated market or trading platform).

The scope of these provisions will be widened by the introduction of a new concept of an organised trading facility ("OTF") defined as any system or facility (not being a regulated market or MTF) operated by an investment firm or market operator in which multiple third-party buying and selling interests in financial instruments are brought together to form a binding financial contract within the scope of MiFID. This definition is therefore designed to catch a wide range of organised trading platform including broker crossing systems. OTFs will also now become subject to MiFID authorisation and conduct of business rules including best execution obligations. Client orders in an OTF will not be permitted to be executed against the proprietary capital of the firm operating the OTF.

Pre- and Post-Trade Transparency

The pre-trade transparency requirements are aimed at providing investors with public information about current trading opportunities including bid and offer prices. Post-trade transparency requires the provision of public information for concluded trades helping market participants facilitate price formation and comply with their execution duties. The Commission's stated aim is that all organised trading should be conducted on regulated markets, MTFs or OTFs and identical pre- and post-trade transparency requirements should apply to each of these venues. The requirements will, however, be calibrated for different types of instruments and different types of trading.

Equity and Equity-like Instruments

Shares admitted to trading on a regulated market (including where traded on an MTF or over-the-counter) are already subject to transparency requirements under MiFID. The new transparency requirements are set out in MiFIR and are extended to all shares traded on an MTF or OTF. The draft legislation also extends the rules to equity-like instruments including depository receipts, exchange-traded funds and similar financial instruments.

The Commission states in the Explanatory Memorandum to MiFIR that existing waivers for the application of the pre-trade transparency regime will be made more consistent and coherent. It notes the primary purpose of waivers is generally to prevent information in relation to large-scale transactions giving distorted picture of the market. The area is, however, a sensitive one due to concerns over the increasing use of "dark pools" in professional markets where pre-trade transparency information is not published. Competent authorities will be permitted to grant pre-transparency obligation waivers based on the market model or the type and size of orders and are required to inform ESMA about their use of waivers. It is intended that ESMA will publish an opinion as to the compatibility of such waivers with MiFIR. The Commission is required to specify the scope of waivers in delegated acts.

In relation to post-trade transparency, it is proposed that details should be made public as close to real-time as is technically possible. In this regard, the previous Commission consultation paper indicated the time in which such information would generally be required would be reduced from 3 minutes to 1 minute and this is likely to be included in amendments to the MiFID implementing directive. Competent authorities will be able to allow deferred publication of certain transactions based on their type or size. ESMA is required to monitor the application of such delayed publication permissions and submit an annual report to the Commission on how they are applied in practice.

Non-equity Markets

The draft MiFIR also extends the pre- and post-trade transparency rules to bonds, structured finance instruments, emission allowances and certain derivatives. This is one of the more controversial proposals and will have a huge impact on the operation of markets in these instruments and a number of market participants have raised concerns as to the effect on liquidity of certain products.

All bonds and structured products that are (i) admitted to trading on a regulated market or (ii) admitted to trading or traded on an MTF or OTF in respect of which a prospectus has been published will be subject to the transparency rules as will derivatives and emission allowances admitted to trading or traded on MTFs and OTFs.

In relation to the pre-trade transparency requirements, to address some of the concerns raised during the consultation process as to the impact on liquidity, the scope of waivers is wider than in respect of equity instruments. In addition to waivers based on type and size of orders, competent authorities will be permitted to grant waivers either to exempt certain transactions from the requirements or to grant a waiver for certain instruments based on specific characteristics of trading activity and liquidity. Competent authorities will be required to notify ESMA of the intended use of such waivers and it will issue an opinion on whether such waiver is appropriate. In relation to post-trade transparency, publication should again be as near to real time as practicable, with the possibility of deferred publication by reference to the size (in particular those that are large in size for the type of product) or type of transaction.

Controversially (and contrary to CESR's previous technical advice), the regulation also provides that pre- and post-trade transparency should apply to OTC derivatives entered into by a systematic internaliser which are clearing eligible under EMIR as well as those traded on a regulated market, MTF or OTF. Post-trade transparency rules will also apply to all OTC derivatives entered into by a systematic internaliser which are clearing eligible or reported to a trade repository (which, under the current EMIR proposals, is likely to cover the vast majority of OTC derivatives).

Availability of Data and Consolidated European Tape

With a view to improving the quality of data available to market participants, regulated markets, MTFs or OTFs will be required to make post-trade information available free of charge 15 minutes after the execution of the transaction and to offer pre- and post-trade data separately to the public on a reasonable commercial basis. The Commission has the ability, by delegated act, to set out criteria specifying what will be regarded as a reasonable commercial basis.

One aim of the EU Commission is to seek to facilitate the provision of a consolidated European tape. The draft MIFID II sets out conditions for the emergence of consolidated tape providers including detailing the organisational requirements that such providers will need to meet in order to be able to operate such a scheme. Each member state must require a consolidated tape provider to have adequate policies and arrangements in place to collect post-trade information made available under MiFIR, to consolidate it into a continuous electronic data stream, and to make the information available to the public as close to real time as is technically possible, on a reasonable commercial basis. MiFID II sets out minimum information that must be provided.

Transaction Reporting

Under MiFID, transaction reporting refers to the provision of transaction information to regulatory authorities. It is proposed that the existing MiFID requirements will be expanded and also reflect the provisions of the draft recast MAD. All transactions in financial instruments will be required to be reported to competent authorities except instruments which (i) are not admitted to trading on a regulated market or traded on an MTF or OTF, (ii) the value does not depend on a financial instrument admitted to trading on a regulated market or traded on an MTF or OTF and (iii) the trading of cannot have an effect on such a financial instrument.

MiFIR sets out details of the information that is required to be reported including the name and volume of instruments, dates and time and execution and transaction prices. Transactions must be reported as quickly as possible, and not later than the close of the following working day. Reporting can be made either directly by the firm or an Approved Reporting Mechanism ("ARM") on its behalf or by the regulated market, MTF or OTF through whose systems the transaction was completed.

Regulated markets, MTFs and OTFs will be required to store order data in a manner accessible to supervisors for at least 5 years. To avoid double reporting of trades under MiFID and EMIR, trade repositories will be required to transmit reports to competent authorities.

The Commission also has the ability after a two-year review to introduce a requirement that transaction reporting be made directly to a system appointed by ESMA.

Exchange Trading of Derivatives

MiFIR contains provisions designed to comply with the agreement made by the G20 at its September 2009 summit to move trading in standardised OTC derivatives to exchanges or electronic platforms by the end of 2012. It requires financial counterparties under EMIR and non-financial counterparties that are subject to a clearing obligation under EMIR to conclude transactions in derivatives that are specified to be subject to a trading obligation either on a regulated market, MTF, OTF or third country trading venue that the Commission has determined is subject to equivalent requirements in non-EU jurisdictions and meets certain other conditions. The operator of a regulated market is required to ensure that all transactions in derivatives that are subject to the clearing obligation under EMIR and are concluded on the regulated market are cleared by a central counterparty ("CCP").

In determining which derivatives should be subject to a trading obligation and the date from which such obligation commences, ESMA is required to develop implementing technical standards. The obligation can only apply to a class of derivatives (or subset) that is admitted to trading on at least one regulated market, MTF or OTF and is considered sufficiently liquid to trade only on such venues. In developing its standards, ESMA is required to consider the class of derivates or a relevant subset as sufficiently liquid by reference to the average frequency of trades, their average size and the number and type of active market participants. ESMA is required to undertake a public consultation before publishing its technical standards. ESMA will also be required to publish and maintain on its website a register of derivatives that are subject to the exchange trading obligation.

Although this requirement was fully expected due to the G20 agreement and the previous consultation paper, concerns remain that these requirements could have a significant impact on the liquidity of certain products, notwithstanding the requirement that only sufficiently liquid instruments be subject to the exchange trading obligation. The ESMA consultation and subsequent rule making are therefore likely to generate significant market interest.

Also of interest, will be a comparison of the final MiFIR rules in relation to exchange trading of derivatives with those in the U.S. Dodd-Frank requires swaps subject to a clearing requirement to be executed on a market exchange or "swap execution facility." The rules in relation to swap execution facilities are still in development but there are concerns amongst many U.S. swap dealers that they could be less flexible than the MiFIR concept of an OTF. Of particular concern and interest will be the development of the pre-trade transparency requirements in relation to quotes both under MiFIR and Dodd-Frank. There will be concerns both in Europe and the U.S. that if one set of rules is regarded as significantly more onerous or less flexible than the other, it could lead to regulatory arbitrage or a significant transfer of business from one market to the other.

Product Intervention

Amongst the more controversial proposals in the previous consultation paper was the Commission indicating that it wanted to introduce the power to ban certain investment services and activities in certain financial instruments to protect investors, market stability or integrity, and to bestow competent authorities with power to intervene, in particular in relation to derivatives, including the imposition of position limits. Subsequent action by national regulators this year in the EU has, however, demonstrated that many authorities already have considerable powers, including under national legislation to intervene in financial instruments, including having the power to ban products. The FSA in the UK has published a consultation paper and feedback statement on product intervention during 2011[4] and the French, Belgian, Danish and Italian regulators have all imposed various obligations in relation to sales of certain complex or illiquid products.

The draft MiFIR provides that ESMA can take action to prohibit or restrict the marketing, distribution or sale or a type of financial activity or practice where it is addressing a threat to investor protection or to the orderly functioning and integrity of financial markets or the stability of all or part of the EU's financial system and existing regulatory obligations are not sufficient and the relevant competent authority or authorities have not taken appropriate action to deal with such threat. In taking such action, ESMA is required to take into account any detrimental effect on the efficiency of markets that such action may have or the likelihood of regulatory arbitrage. ESMA must give prior notice of any such action to relevant competent authorities and publish details of such action on its website. Any such action must be reviewed and renewed each three months or it will expire.

Competent authorities also have the power under MiFIR to prohibit or restrict in their member state, the marketing, distribution or sale of certain financial instruments or instruments with particular features or a type of financial activity or practice on the same ground as ESMA. Any such action must be proportionate, taking into account the nature of the risks identified, the level of sophistication of investors or market participants concerned and the likely effect of the action on investors and market participants. It must also consult with competent authorities in other member states that may be affected by the action and its action must not have a discriminatory effect on services or activities provided from another member state. The relevant authority must give not less than one month's notice of such action to other competent authorities and ESMA and shall publish details of the relevant action on its website.

ESMA is required to perform a coordinating role in relation to any such action taken by competent authorities and satisfy itself that such action is justified and proportionate (and provide an opinion on such question) and that, where appropriate, a consistent approach is taken by other competent authorities.

ESMA also has the power to request information from any person in relation to the size and purpose of any position or exposure entered into pursuant to a derivative and, if appropriate, require the reduction of a particular position or exposure. It can also limit the ability of a person to enter into a commodity derivative. Any such action must be on the grounds that it addresses a threat to the orderly functioning and integrity of financial markets or the stability of the whole or part of the EU financial system and relevant competent authorities have not taken measures to address the threat or such measures do not sufficiently address the threat. ESMA is

[4] See our client alerts, "FSA Product Intervention," http://www.mofo.com/files/Uploads/Images/110314-FSA-Product-Intervention.pdf and "Product Intervention in the UK and the new FCA," http://www.mofo.com/files/Uploads/Images/110705-Product-Intervention-in-the-UK-and-the-New-FCA.pdf.

required to notify relevant competent authorities of any such proposed action and any notification shall, other than in exceptional circumstances, be made not less than 24 hours before the measure is intended to take effect or be renewed. ESMA shall also publish details of such action on its website.

The proposals therefore give considerable powers to ESMA to take product intervention action in addition to national authorities and also to seek to ensure that national measures are taken on a more coordinated basis. Although this is likely to give rise to concerns, particularly at a national political level, that such provisions are oiling the wheels to transferring significant national powers to ESMA, some market participants are likely to welcome any product intervention measures being imposed on a more consistent and coordinated basis in the EU. There have been concerns that some of the recent action by national authorities has been on a piecemeal and uncoordinated basis, giving rise to an unlevel playing field in some products across the EU. The ability of ESMA to impose position limits in relation to derivatives met with considerable resistance in the consultation process and is likely to remain an issue for debate as MiFIR and MiFID go through the legislative process.

Non-Discriminatory Clearing Access for Financial Instruments

One issue not discussed in the previous consultation paper that has become politically charged, including in relation to negotiations on EMIR, is the question of discriminatory practices in relation to the clearing of financial instruments. Jurisdictions such as the UK have pushed for open access to clearing houses. This has met resistance in some jurisdictions, including Germany, where a vertical integration model between trading and post-trading infrastructure is common. For example, any trade currently conducted on Frankfurt's Eurex exchange is required to be cleared through its own clearing house.

The draft MiFIR provides that any trading venue under the ambit of MiFID must provide open access, including the provision of trade feeds, on a non-discriminatory basis to any CCP authorised or recognised under EMIR that wishes to clear financial transactions executed on such venue. Similarly, each CCP is required to accept financial instruments that it clears on a non-discriminatory basis, including in relation to fees and collateral arrangements. Such obligations will not, however, apply where it can be shown, in either case, that such access would threaten the smooth or orderly functioning of markets. Such determination must be made by the relevant competent authority and it must publish full reasons to the relevant parties, including the evidence on which its decision is based.

Provision of Financial Services in the EU by Non-EU Firms

The drafts of MiFIR and MIFID II propose a harmonised framework for granting access to EU markets for firms and market operators based outside the EU. Currently, where financial services are provided by the branch of a non-EU entity, there is a fragmented approach between different member states as to the terms on which such branches can operate and no ability for services provided by such an entity in one member state to be passported into another member state.

The draft MiFID II provides that any provision of services to retail clients by a non-EU firm would require the establishment of a branch in an EU member state. This will involve the authorisation of the firm in the member state where the branch is established. The branch would be subject to certain MiFID requirements including organisational requirements, conduct of business rules and conflicts of interest. To be authorised, the branch will need to be from a jurisdiction where the Commission has determined that the legal and supervisory arrangements in such jurisdiction are equivalent to the provisions in MiFIR, MiFID and the Capital Requirements Directive, and certain other requirements are satisfied, including such jurisdiction having provisions for equivalent reciprocal recognition and cooperation arrangements with the competent authorities in the relevant member state, including in relation to the exchange of information. Once such a branch is authorised, it will be able to conduct business across other EU member states without the need for further authorisation.

In relation to firms providing services to eligible counterparties in the EU, they will be permitted to do so under MiFIR without the establishment of a branch by being registered by ESMA, which will keep a register of such entities. Registration may only be made where the EU Commission has made an equivalence determination in respect of such jurisdiction as outlined above. ESMA is required to establish cooperation arrangements with the competent authorities of such jurisdictions, including exchange of information.

The establishment of an equivalence regime in respect of services provided by entities from non-EU member states caused some concern to respondents during the consultation process. There are some fears that the provisions may result in reciprocal provisions being introduced in other jurisdictions, including the U.S., which may harm the ability of EU entities to do business in such jurisdictions or at least increase the costs and administrative burden of doing so.

Scope of Directive and Investor Protection

A number of amendments are made to the investor protection provisions under the draft of MiFID II including:

- As recommended in the Commission's PRIPs consultation, the scope of MiFID is widened to cover firms selling or advising clients in relation to structured deposits. These are defined widely as "deposits other than those with a rate of return which is determined in relation to an interest rate."
- Firms that deal on their own account by executing clients orders are now within the scope of MiFID.
- The optional exemption for member states in respect of firms that do not hold client funds or securities and do not provide any investment service except providing investment advice or the reception and transmission or orders, is restricted to circumstances where such firms are authorised and regulated at national level under requirements that are at least analogous to MiFID II provisions relating to authorisation, supervision and conduct of business.
- Only relatively minor changes are made to the client classification definitions. Local authorities will be excluded from the definition of eligible counterparty and, in relation to eligible counterparties, a requirement is added that member states shall ensure that in their relationship with eligible counterparties, investment firms act honestly, fairly and professionally and communicate in a way which is fair, clear and not misleading in the circumstances.
- When providing investment advice, the firm will need to state whether this is provided on an independent basis and whether it is based on a broad or more restricted analysis of the market and shall indicate whether the firm will provide the client with an ongoing assessment of the suitability of financial instruments. Where a firm states that advice is provided on an independent basis, it must assess a "sufficiently large" number of financial instruments available on the market and shall not accept or receive fees or commissions paid or provided by any third party in relation to such service.
- Firms providing investment advice or portfolio management will not be permitted to receive fees or other inducements paid or provided by any third party.
- Although the Commission had in its previous consultation paper considered abolishing the "execution only" exemption where non-advised services can be provided to clients, including retail clients on an execution-only basis without an appropriateness assessment being carried out as to the knowledge and experience of the client, the exemption remains although some changes have been made to it. To fall within the exemption, bonds, other forms of securitised debt or money market instruments must (in the case of bonds and securitised debt) be admitted to trading on a regulated market (or equivalent market in a non-EU jurisdiction) or MTF and must not embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved. ESMA is required to develop guidelines as to what will incorporate structures that make it difficult for the client to understand the risks involved in a

financial instrument. Previously all UCITS products fell within the execution-only exemption. The draft regulation now excludes structured UCITS from such treatment.

- Some amendments are made to the best execution obligations, including that information provided by firms to the clients on their order execution policy should explain clearly, in sufficient detail and in a way that can be easily understood by clients, how orders will be executed by the firm for the client. Firms will also be required to summarise and make public on an annual basis, the top five execution venues where they executed client orders for each class of financial instrument.
- Tied agents will be prohibited from handling client's money and/or financial instruments.

These amendments are largely consistent with the proposals set out in the consultation paper. Although they do not represent sweeping changes to the scope of MiFID or the investor protection provisions, they nevertheless make some important changes that are likely to have an important impact and impose additional costs in respect of certain activities. There will, however, be relief that some of the more controversial suggestions in the consultation paper including the possible abolition of the execution-only exemption and the proposal that firms could no longer assume the knowledge and experience of professional investors, have not found their way into the final proposals.

Commodity Derivatives and Emissions Allowances

The draft regulation makes a number of significant changes in relation to the regulation of commodity derivatives. Currently MiFID contains exemptions in relation to persons who deal on their own account as an exclusive activity, as an ancillary part of another non-financial corporate activity or as part of a non-financial commodity-trading activity. The draft directive limits these exemptions so that they do not apply to firms dealing on their own account in commodity derivatives or emissions allowances as an ancillary activity to part of another non-financial corporate entity. The general exemption relating to persons whose main business consists of dealing on their own account in commodities or commodity derivatives is removed.

Member states will also be required to ensure that regulated markets, MTFs and OTFs which admit commodity derivatives impose position limits in relation to such activities. They will also be required (subject to exceeding specified thresholds) to publish a weekly report with the aggregate positions held by different categories of traders for different financial instruments and, upon request, provide the relevant competent authority with a full breakdown of position information for the members, including positions held on behalf of clients. As mentioned above, ESMA will also have the power to limit the ability of a person to enter into a commodity derivative.

Emission allowances did not previously come expressly within the ambit of MiFID. Concerns on the part of the EU Commission that certain fraudulent practices that have occurred in spot markets could undermine trust in the emissions trading scheme ("ETS") in the EU, have resulted in the draft proposal specifying emissions allowances as a financial instrument subject to regulation. This is likely to have a major impact on traders and advisors in the ETS market, many of whom are not currently subject to regulation under MiFID.

Automated Trading Including Algorithmic and High-Frequency Trading

The EU Commission has previously raised concerns about the potential threat to markets and market stability arising from algorithmic and high-frequency trading. To seek to address these concerns, a new article is proposed to be added to MiFID II providing that an investment firm that engages in algorithmic trading must have effective systems and risk controls in place to ensure that its trading systems are resilient and have sufficient capacity and are subject to appropriate trading thresholds and limits. It will also need to provide annual reports to its home competent authority of, among other things, the nature of its algorithmic trading strategies and details of the trading parameters or limits in the system and key compliance risk controls. Regulated markets will be required to have efficient systems, procedures and arrangements in place to ensure algorithmic trading systems cannot create or contribute to disorderly trading conditions, including circuit breakers to stop trading if there are significant changes in market prices in a short period.

Firms that engage in algorithmic trading strategy will also be required to ensure that they publish firm quotes at competitive prices with the result of providing liquidity on a regular and ongoing basis to the relevant trading venues at all times, regardless of prevailing market conditions.

ESMA will be required to prepare a report within 2 years of the new arrangements coming into effect on the impact of the requirements in relation to automated and high-frequency trading.

SME Markets

With the stated aim of making SME markets more attractive to small companies and investors, the draft regulation includes proposals for a proportionate regime for SME markets. The operator of an MTF may apply to its home competent authority to be registered as an SME growth market, provided it meets certain conditions, including that the majority of issues whose financial instruments are admitted to trading on the MTF are SMEs. It is envisaged that further details as to criteria for admission to trading and regulatory standards for such markets will be further prescribed in delegated acts or technical standards.

Supervisory Powers

As referred to above, ESMA and competent authorities have additional powers in relation to product intervention including being able to prohibit or restrict the marketing, distribution or sale of a product to address threats to investor protection, the orderly functioning of financial markets or EU financial stability.

The draft MiFID II also includes some additional powers (which are already very wide under MiFID) for competent authorities to require data and information, including being able to demand documentation or information in relation to the size and purpose of a position or exposure entered into through a derivative. Competent authorities will also have express powers to require the freezing and/or sequestration of assets, require the suspension of trading in financial instruments or require the removal from trading of a financial instrument. It is likely, however, that most competent authorities will already have many of such powers under their national rules.

Competent authorities will also be required to comply with certain minimum rules in relation to imposing administrative sanctions in relations to breaches of MiFIR and MiFID.

Next Steps and Impact of Draft Legislation

As can be seen from the above summaries, the new MiFID II and MIFIR proposals will have a major impact upon the regulation of financial services in the EU and the operation of regulated markets and trading platforms. Most of the proposals were contained in the Commission's previous consultation paper but a number of market participants will be disappointed that, despite concerns being raised during the consultation process as to the impact of the provisions, some of the more controversial proposals remain largely in the form proposed. These include extending the pre- and post-trade transparency regime to non-equity and to some OTC transactions, the increased powers for national regulators and ESMA to intervene in product development, marketing and selling, the equivalence regime for non-EEA firms and the effect of the proposals on the commodity derivatives and emissions trading markets. ISDA has already raised concerns that the approach taken on organised trading, particularly for derivatives, go well beyond the scope of the G-20 agreement. There is, however, relief in some quarters that some of the proposals in relation to conduct of business and investor protection have been relaxed from the position set out in the consultation paper.

The draft legislation, however, only marks the start of the legislative process. There will no doubt be considerable discussion as the proposals are considered by the EU Parliament and Council and it is likely that some of the proposals will be subject to modification. Market participants are therefore likely to continue to raise concerns as to the impact of certain provisions. As has been seen with the discussions in relation to EMIR (which has not yet been finalised despite the draft legislation first being published over a year ago), the EU legislative process can be drawn out. The Commission will however be keen to ensure that the drafts get finalised as soon as possible and well ahead of the G-20 end-2012 deadline that applies in relation to implementing some of the provisions.

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News Bulletin

October 20, 2011

ESMA Final Report on Summaries and Final Terms Under the Prospectus Directive

As we reported in our earlier alert,[1] the European Securities and Markets Authority was required to deliver, by 30 September 2011, its final technical advice to the European Commission in relation to possible delegated acts under the amended Prospectus Directive. Its advice came in a few days late,[2] which fuelled certain hopes in some people that this signalled a re-think of many of the more radical proposals in their June 2011 Consultation Paper. These hopes have proven largely unfounded and very few of the responses received to the consultation have resulted in a change of position from ESMA.

We have drawn out, in the following paragraphs, some of the more notable comments and responses in respect of the technical advice on the format of final terms and summaries.

General Observations

ESMA freely acknowledges comments that the proposals will reduce the flexibility of the base prospectus regime under the Prospectus Directive, but considers its approach is necessary to stem what it perceives as practices that abused the intent of the regime by circumventing the prospectus vetting process. ESMA considers that its approach provides clarity as to what can and cannot be included in final terms and that any resulting approval delays or additional costs should be addressed at some point in the future.

ESMA states that it is fully aware of the impact of its technical advice on the structured products industry. It still considers that structured products can be issued by a base prospectus and final terms, but regards many existing structured note programmes as lacking in readability and comprehensibility by virtue of a lack of clear presentation of complex product terms.

Most commentators pointed out that base prospectuses would become lengthier due to ESMA's approach, resulting in them becoming less comprehensible. ESMA states that it sees no linkage between the length and comprehensibility of a document, thereby avoiding the undeniable fact that a longer disclosure document is more likely to deter an investor from reading it, thereby leading to lack of comprehension on the investor's part.

Some commentators also expressed the view that the ESMA proposals went beyond the scope of the Prospectus Directive, and were disproportionate to the goal of eliminating inconsistencies in the use of final terms. Perhaps not surprisingly, ESMA disagrees with this view, though it chose not to go into detail as to its reasons.

[1] See Morrison & Foerster client alert "The Changing Face of European Securities Issuance," http://www.mofo.com/files/Uploads/Images/110729-Changing-Face-of-European-Security-Issuance.pdf.
[2] Final Report, http://www.esma.europa.eu/popup2.php?id=7983.

Prescriptive Lists and Additional Information

In ESMA's view, only prescriptive lists (as opposed to general principles) of securities note items should be permitted in final terms. One of the few concessions that ESMA makes to flexibility is the ability of final terms to contain information ("Additional Information") not required by the securities note schedules in the Prospectus Regulation. However, pleas to make any list of permitted Additional Information items flexible, rather than exhaustive, have fallen on deaf ears.

Commentators note that, in the interests of information being useful to investors, any exhaustive list of Additional Information should also contain items such as country-specific information, selling restrictions, inducements paid to distributors, product-specific risk factors and descriptions of conflicts of interest. ESMA has at least agreed to take more time to consider these issues and has conceded that the exact content of the list will be determined only at a later stage.

Interestingly, ESMA's final advice to the Commission in this regard expressly acknowledges that the Prospectus Directive and Regulation expressly state that final terms may only contain information from the securities note schedules, but that it still thinks the Additional Information items (when prescribed) will be "useful to investors." Whilst noble in purpose no doubt, this is a novel argument to put forward for "gold-plating" a maximum harmonisation directive and regulation.

Category A, B and C Information

As it did in its previous consultation paper, ESMA has put each item in the securities note schedules in the Prospectus Regulation into either category A (where the information must be included in the base prospectus and no additional information can be included in final terms), category B (where the base prospectus must contain the general principles of such item and can only leave placeholders for the details which are not known at the time of drawing up the base prospectus) or category C (where the final terms should fill in the details of a placeholder (but not replicate any information) in the base prospectus).

Many respondents argued that any securities note information items not known at the time of the base prospectus could be contained in final terms. However, ESMA's firm stance is that only certain categories of information, which are unknown at the time of the base prospectus, may be included in the final terms.

Some respondents noted that this formalistic approach, while constituting a somewhat artificial and arbitrary categorisation methodology for issuers to apply, resulted in a simpler and more streamlined approach to scrutiny by the competent authorities. ESMA stated that this had not been the driving factor behind its approach.

ESMA's proposal for Category B-designated information items was that the base prospectus should contain all the general principles of such item and placeholders for relevant details not known at the time of the base prospectus. The final terms may then replicate the principles and fill out the placeholders. ESMA proposed in its Consultation Paper that the list of relevant details should be a limited one, consisting of only items such as amounts, currencies, dates, times, percentages, etc. While ESMA still considers that there must be a limited list of such items, it now proposes to determine the contents of such list only at some point in the future.

"Long Form" Final Terms

ESMA's restrictive interpretation of Article 26(5) of the Prospectus Regulation, as meaning that information items contained in the base prospectus may not be reproduced in the final terms document, has met with much consternation from market participants in certain countries, Germany in particular.

In such countries, it has become customary for issues to retail investors to set out, in the final terms document, the entire terms and conditions of an offering. This practice will seemingly become outlawed if the European Commission agrees with the technical advice given by ESMA in this regard.

Supporters of this practice might argue to ESMA that it is useful for an investor to have all this information set out in one place – "usefulness" being the express justification cited by ESMA for departing from the mandatory provisions of the prospectus regime in respect of Additional Information, as noted above.

Some respondents expressed their view that issuers would have difficulty meeting national-level civil law requirements if this practice were no longer permitted, but ESMA states that it regards this as a problem to be solved by the nation's lawmakers, not by it or the prospectus regime.

Prospectus Summary

ESMA largely maintains its position in relation to prospectus summaries as set out in its previous consultation paper, including that the summary be split into five prescriptive sections (including risk warnings) and no information be permitted that does not fall within one of the permitted categories. The existing 2,500-word limit for summaries will be replaced with a limit of the shorter of 15 pages or 7% of the length of the base prospectus. No cross referencing to other sections of the base prospectus will be permitted.

Final Term Summaries

As in the consultation paper, ESMA recommends that a separate summary for each issuance off the base prospectus should be annexed to the relevant final terms. The length limit would be the same as for the prospectus summary referred to above. Such summary will also be subject to the same translation requirements as the prospectus summary. ESMA rejected arguments that this translation requirement would be contrary to the principles of the base prospectus regime and would give rise to significant delays in the "passporting" system established by the base prospectus regime.

Concerns remain as to how the new final term summary requirements interact with the EU Commission's current proposals in relation to packaged retail investment products ("PRIPs") which currently envisage the production of a short-form key investor information document ("KIID") of no more than two pages containing key information for investors. It seems unlikely that the final terms summary envisaged by ESMA would be such a short document, giving rise to the prospect of issuers having to prepare both a KIID and final terms summary for securities that could be sold to retail investors. ESMA has asked the European Commission to consider how its proposals in relation to summaries and the Commission's KIID proposals in relation to PRIPs can be aligned, but at present, it appears that the respective aims of the two documents are very different.

Wholesale/Retail Distinction

Criticisms were raised that requiring such levels of scrutiny by competent authorities for all issuances was inappropriate for qualified investors and that the current approach does not distinguish between these investors and retail investors. ESMA's response was that the Prospectus Regulation already provides for lower levels of minimum disclosure for non-retail offerings, but otherwise states that issuers are always free to develop separate base prospectuses for their wholesale and retail issuances.

Items for Inclusion in Base Prospectuses

ESMA remains adamant that risk factors and pay-out formulae are items for base prospectuses – not final terms. It acknowledges that changes such as these will inevitably mean that some types of issuance's will no longer be made via final terms, but is not convinced that financial innovation will suffer as a result.

Proprietary Indices

ESMA will distinguish, in its approach, between proprietary and non-proprietary indices, with the former having to be contained in the base prospectus. As with other aspects of ESMA's proposals, this will lead to longer prospectuses, though as they have stated, ESMA does not accept that this gives rise to a lack of comprehension by the investor.

Asset-backed Securities

Following pressure from respondents, the information item "General description of the obligors and their economic environment" has been reclassified by ESMA from Category A to Category B, to reflect the fact that certain obligor information, such as pool-specific statistical information, may not be available before the issue date.

Swap Counterparties

Since arrangements can be series-specific, the identity of the swap provider may not be known at the issue date. Nevertheless, ESMA still believes that such information should remain a Category A item.

Next Steps

Unless there is a further amendment to the Prospectus Directive, the Commission is obliged to adopt delegated acts by 1 July 2012, although it is not obliged to adopt the proposals made by ESMA and it has the power to weigh up ESMA's advice against other possible delegated acts. It would, of course, be something of a surprise if it did not adopt the majority of ESMA's recommendations, though, and set in motion the legislative machinery for what may come to be known as "PD2."

A likely consequence of ESMA's proposals is that issuers will be subject to greater costs and administrative burdens in relation to production of additional prospectus supplements in relation to information which could currently be contained in final terms. As mentioned above, this is likely to be a particular issue in relation to structured securities. One possible consequence is that the proposals may lead to issuers having multiple programmes, each designed for a specific type of product. It may also have the consequence that some issuers may decide that the cost of issuing retail products (particularly structured retail products) is too great and they will only issue notes in wholesale denominations. This would be likely to result in a reduction of choice for retail investors.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

Morrison & Foerster News Bulletin Volume 2, Issue 10 July 27, 2011

Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

FINRA's Proposed Revisions to Rule 2210, Communications with the Public: Expected Impact on the Structured Products Market

Introduction

In July 2011, FINRA proposed to amend several of its rules relating to broker-dealers' communications with the public.[1] These rules relate to a number of areas, and potentially impact a wide variety of securities offerings.[2] In this article, we address the potential impact of these proposals on offerings of structured products, and the documents used in these transactions.

The rules were initially proposed for amendment in September 2009. FINRA's revised proposal reflects, among other things, a variety of comments that it received from industry participants. The proposals also reflect FINRA's continuing interest in offering activities relating to the structured products market.

[1] The text of the proposed rules may be found at the following web page: http://www.finra.org/Industry/Regulation/RuleFilings/2011/P123894.

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

New Filing Requirements Relating to Structured Products (and Exemptions from Filing)

Filing Requirements. New Rule 2210(c)(3)(F) would require broker-dealers to file with FINRA "retail communications concerning any security that is registered under the Securities Act and that is derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency." [3]

The filing would be required to be made within 10 days of the first use or publication of the relevant communication, and would be made with FINRA's Advertising Regulation Department.[4] The filing would not need to be made prior to the use of the document, as was contemplated by FINRA's September 2009 rule proposal.[5]

These provisions would apply to the documentation used in a wide variety of retail structured notes. However, we would note that, based upon the text of the provision above, the filing requirement would not apply to certain types of structured products, such as:

- structured products that are bank certificates of deposit or unregistered bank notes (they are not registered under the Securities Act); and
- rate-linked products, such as step-up callable notes, which are not included in the text of the proposed rule.

The proposed filing requirement reflects FINRA's continuing interest in the marketing materials used for structured products. The filings would provide FINRA with an enhanced opportunity to review and comment on these documents, as well as to take steps to challenge any disclosure practices of which it does not approve.

Exemption from Filing for Certain Materials. Proposed Rule 2210(c)(7)(E) would exempt from the filing requirement any prospectuses, preliminary prospectuses, offering circulars, or similar documents that have been filed with the SEC. This exemption would remove a wide variety of prospectuses and free-writing prospectuses from the filing requirements, since so many of them are in fact filed with the SEC under Rule 424(b) or Rule 433. However, this provision would not exempt from filing free-writing prospectuses that have been filed with the SEC under Securities Act Rule 433(d)(1)(ii). Rule 433(d)(1)(ii) is the provision that requires underwriters to file those free-writing prospectuses that they distribute "in a manner reasonably designed to lead to its broad unrestricted dissemination." (Typically, this occurs by posting a document on an unrestricted website.) We refer to these types of FWPs as "broadly disseminated underwriter FWPs."

This is not the first time that FINRA has focused on broadly disseminated underwriter FWPs. In its Regulatory Notice 10-52 (October 2010),[6] FINRA indicated that the content standards and principal review requirements of existing Rule 2110 would apply to these documents. In this notice, FINRA indicated that it had observed that a variety of these documents used by FINRA members were not in compliance with existing Rule 2110's content standards. Accordingly, the proposed new rules continue this focus on these types of documents by seeking to ensure that they are filed with FINRA for potential review.

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[3] The term "retail communication" would include any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30-calendar-day period. (The "retail communication" term would replace a number of related definitions that exist in FINRA's current rules.) The term "retail investor" would include any person other than an institutional investor (as defined under the FINRA rules), regardless of whether the person has an account with the member. (These new definitions would be set forth in Rule 2210(a).)

[4] FINRA's website contains instructions for effecting filings with the department: http://www.finra.org/web/groups/industry/@ip/@edu/documents/education/p017549.pdf.

[5] Such a pre-filing requirement could dramatically slow financial innovation, due to the amount of time that would pass between the time of the FINRA filing and the time at which the materials could be provided to investors. In contrast, certain different types of materials must in fact be filed prior to their first use, such as certain retail communications used by a new FINRA member during its first year of membership. (Proposed Rule 2210(c)(1)(A).)

[6] Available at: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122310.pdf. We discuss this notice in Volume 1, Issue 14 of Structured Thoughts: http://www.mofo.com/files/Uploads/Images/101026-Structured-Thoughts.pdf.

We note that the text of the proposed rule would remove the exemption for broadly disseminated underwriter FWPs that "have been filed with the SEC under Securities Act Rule 433(d)(1)(ii)." Under a strict reading of this provision, having the issuer file such an FWP under Rule 433(d)(1)(i) (which relates to "issuer FWPs") would appear to remove the FWP from the filing requirement.[7] However, this reading seems to be at odds with the intent of the proposed rule, and FINRA's interest in reviewing these documents. As a result, a variety of FWPs used and posted by underwriters on unrestricted websites would become subject to FINRA's filing requirements. These materials include various types of product descriptions, and materials used to educate investors about structured products.

Principal Approval Requirements

Proposed FINRA Rule 2210(b)(1)(A) would require an appropriately qualified registered principal of the member to approve each retail communication before the earlier of its use or filing with FINRA. This provision is similar to the current FINRA requirements.

Adequacy of Communications

Existing Rule 2210(d)(1) requires a FINRA member's communications to be fair, balanced, and accurate. Proposed Rule 2210(d)(1) would be supplemented to specify that:

- Members must ensure that statements are clear and not misleading within the context in which they are made, and that they provide balanced treatment of risks and potential benefits. For example, communications must be consistent with the risks of fluctuating prices and the uncertainty of dividends, rates of return, and yield. (Proposed Rule 2210(d)(1)(D).)
- FINRA members must consider the nature of the audience to which the communication will be directed, and must provide details and explanations appropriate to the audience. (Proposed Rule 2210(d)(1)(E).)

As to structured products, these provisions reflect FINRA's continuing concern with the adequacy of risk disclosures. The proposed rule also recognizes that different investors may have different levels of understanding of different products, and that members need to tailor their retail communications in light of these factors.

Internal-Use Only Communications

Proposed supplementary material ".01" to Rule 2210 would apply certain FINRA guidance to internal-use only materials. The new material would provide that a member's internal written communications that are intended to educate or train registered persons about the member's products or services would be considered "institutional communications" under paragraph (a)(3) of FINRA Rule 2210. As a result, these internal communications would be subject to both the provisions of proposed FINRA Rule 2210 and NASD Rule 3010(d).[8]

Under proposed new Rule 2210(b)(3), each member must establish appropriate written procedures for the review by an appropriately qualified registered principal of these written materials. The procedures must be reasonably designed to ensure that these institutional communications comply with applicable standards. If these procedures do not require review of all institutional communications prior to their first use or distribution, they must include provisions for the education and training of a member's personnel as to the member's procedures governing institutional communications, documentation of that education and training, and surveillance and follow-up to ensure that the procedures are implemented and adhered to. The member must maintain evidence that these supervisory procedures have been implemented and carried out, and must make this evidence available to FINRA upon request.

[7] And as a practical matter, most broadly disseminated underwriter FWPs used in the structured products world are filed by the issuer, since the FINRA member is usually underwriting securities of its parent corporation, which effects the FWP filing under Rule 433.
[8] NASD Rule 3010(d) governs the supervision and review of written correspondence.

These proposals echo some of FINRA's concerns articulated in its 2011 consent agreement with UBS relating to sales of Lehman Brothers' "principal protected" structured notes.[9] In that agreement, FINRA focused on whether UBS's internal materials were sufficient to alert members of the sales force as to the risks relating to investments in Lehman Brothers' securities. The new proposal is designed in part to help ensure that internal materials created to educate personnel as to instruments such as structured products are sufficient, balanced, and appropriate.

Spot Checking

Proposed Rule 2210(c)(6) provides that each member's written communications may be subject to a spot-check procedure, and that members must submit requested material within the time frame specified by FINRA. This provision is generally consistent with current rules, and provides a basis for FINRA to review communications and related procedures (as to both retail and institutional communications) that are governed by the rules.

Record-keeping Requirements

Proposed FINRA Rule 2210(b)(4)(A) would update FINRA's record-keeping requirements for retail and institutional communications. These requirements would be similar to FINRA's current record-keeping requirements. This provision would incorporate by reference the record-keeping format, medium, and retention period requirements of Rule 17a-4 under the Exchange Act.

The proposed rule specifies that these records would need to include, among other items:

- a copy of the communication and the dates of first and (if applicable) last use;
- the name of any registered principal who approved the communication and the date that approval was given;
- in the case of a retail communication or institutional communication that is not approved prior to first use by a registered principal, the name of the person who prepared or distributed the communication; and
- information concerning the source of any statistical table, chart, graph, or other illustration used in the communication.

Status of Proposed Rules, and Potential Impact

The SEC may approve or reject these rules 45 days after their publication in the Federal Register. The SEC may also designate a longer period for review, or initiate proceedings to determine whether the proposed rule change should be disapproved.

If the SEC approves the proposed rules, FINRA would publish a regulatory notice of the rule change within 90 days thereafter. In its proposal, FINRA states that the implementation date for the new rules would be within one year of the SEC approval. This period would enable broker-dealers to update their policies and procedures to comply with the new rules.

The proposed rules would extend FINRA's filing requirements to a significant number of documents that are used to market structured products. The filing would provide FINRA with an additional opportunity to review and comment on these documents. FINRA may use this opportunity to provide guidance to the market as to its preferred practices in the area, and/or to take disciplinary action against those issuers that do not maintain disclosures and policies that are consistent with its rules. The implementation period will provide members with an opportunity to update their practices and policies to reflect the new rules.

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[9] The agreement is available at: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123478.pdf. See pages 10 and 11 of that agreement for a discussion of UBS's internal training materials.

FINRA Warns Investors About Chasing Returns in Structured Products and Other Investments

On July 25, 2011, FINRA issued an investor alert that warns investors about the risks of investing in riskier and sometimes complex products that promise higher returns. FINRA's Investor Alert, "The Grass Isn't Always Greener—Chasing Return in a Challenging Investment Environment," was prompted by significant recent inflows into investments like high-yield bond funds, floating-rate loan funds, and structured retail products.

The alert may be found at the following link:
http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/TradingSecurities/P123947.

The alert does not raise any significant new issues relating to the sale of structured products. However, the alert reflects FINRA's continuing concerns about how these products are marketed, and whether investors understand the nature and risks of these instruments. Regarding structured products, the release recommends that investors focus on, among other things:

- The higher risks that are associated with potentially higher returns.
- The potential lack of liquidity for structured products.
- The costs and fees associated with structured products, the impact of which on the terms of the investment may not be easy to understand.
- Whether the instrument provides the issuer with a call right that could limit the investor's returns.
- The possibility that the return on a "principal-protected" structured product may be less than that of a conventional debt security.

The alert also highlights FINRA's concerns as to leveraged ETFs, which were originally addressed in a 2009 FINRA alert.[10]

State of Georgia Reviewing Offerings of Reverse Convertible Notes

According to recent news reports, the Secretary of State of Georgia, who regulates securities firms, is investigating whether securities laws were violated by the sale of reverse convertible notes and similar securities to Georgia investors. According to a July 21, 2011 report in Bloomberg, the Secretary has issued subpoenas to UBS AG, Morgan Stanley, and Ameriprise Financial Inc. to determine how many reverse convertible notes each of these entities sold in Georgia and the names of the investors. According to a spokesperson for the Secretary's office, "We have multiple investigations open with regard to the sale of reverse convertible notes, and will thoroughly review all evidence to ensure that Georgia investors are protected."

With this investigation, Georgia joins a number of other states, including Texas, Massachusetts, and Alabama, that are reviewing structured product offerings.

[10] See "Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors," http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/P119778.

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

Morrison & Foerster short-listed as *Derivatives Week* magazine's 2011 Law Firm of the Year. The winner will be revealed at a ceremony on September 27, 2011.

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News Bulletin

July 26, 2011

FINRA'S Proposed Rules 2210 and 2211

As part of its continuing effort to create a consolidated rulebook, the Financial Industry Regulatory Authority, Inc. ("FINRA") has proposed a new FINRA Rule 2210 that would subsume, subject to certain changes, the provisions of current NASD Rules 2210 and 2211, NASD Interpretive Materials 2210-1 and 2210-4, and the provisions of Incorporated NYSE Rule 472 that do not pertain to research analysts and research reports (collectively, the "Proposal"). The following client alert provides a brief analysis of some of the significant proposed changes.

Communications Categories

Current Communications Categories

Currently, NASD Rule 2210 divides communications into the following six categories:

- An "advertisement" includes written (including electronic) retail communications that do not have a limited audience, such as newspaper, magazine, television and radio advertisements, billboards and websites.
- "Sales literature" includes written (including electronic) retail communications that have a more targeted audience, such as brochures, performance reports, telemarketing scripts, seminar scripts and form letters.
- "Correspondence" includes written letters, electronic mail, instant messages and market letters sent to one or more existing retail customers or fewer than 25 prospective retail customers within a 30-calendar-day period.
- "Institutional sales material" includes communications that are distributed or made available only to institutional investors.
- An "independently prepared reprint" includes reprints of articles from independent publications, as well as reports published by independent research firms.
- A "public appearance" includes unscripted participation in live events, such as interviews, seminars and call-in television and radio shows.

Historically, FINRA has applied differing approval, filing and content standards to each category of communications above. The filing requirements also differ based on the type of member using the material and the contents of the communication.

Revised Communications Categories

The Proposal would reduce the types of communication categories from six to three, as follows:

- An "institutional communication" would include any written (including electronic) communication that is distributed or made available only to institutional investors.
- A "retail communication" would include any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30-calendar-day period.
- "Correspondence" would include any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30-calendar-day period.

Communications that currently qualify as an advertisement, sales literature or an independently prepared reprint to more than 25 retail investors within a 30-calendar-day period would each now generally be classified as a retail communication. Communications that are currently categorized as institutional sales material would be classified as institutional communications. Some communications that currently qualify as "correspondence," if sent to more than 25 retail investors within a 30-calendar-day period, would be considered retail communications.

Approval, Review and Recordkeeping Requirements

Approval and Review

Currently, NASD Rule 2210(b)(1)(A) requires a registered principal of the member to approve each advertisement, item of sales literature and independently prepared reprint before the earlier of its use or filing with FINRA. Under the Proposal, an appropriately qualified registered principal of the member would be required to approve each retail communication. The principal registration required to approve particular communications would depend upon the permissible activities for each principal registration category.

The Proposal would continue to require that research reports on debt and equity securities be approved by a Series 16 supervisory analyst and would maintain the exception from the principal approval requirements for an advertisement, item of sales literature, or independently prepared reprint, if at the time that a member intends to publish or distribute it: (i) another member has filed it with FINRA and has received a letter from FINRA stating that it appears to be consistent with applicable standards and (ii) the member has not materially altered it and will not use it in a manner that is inconsistent with the conditions of FINRA's letter.

The Proposal would carve out three additional categories of retail communications from the approval requirements, provided that the member supervises and reviews the communications in the same manner as required for supervising and reviewing correspondence pursuant to NASD Rule 3010(d). These communications include:

- Any retail communication that does not fall under the definition of "research report" pursuant to NASD Rule 2711(a)(9)(A);
- Any retail communication that is posted on an online interactive electronic forum; and
- Any retail communication that does not contain a financial or investment recommendation or otherwise promote a product or service of the member.

The Proposal would also allow FINRA to grant an exemption from the principal approval requirements above, provided that the exemption is consistent with the goals of protecting investors and the public interest.

Proposed FINRA Rule 2210(b)(1)(F) would require that an appropriately qualified principal approve any communication that is filed with FINRA, even if a communication would otherwise come under an exception to the principal approval requirements of proposed FINRA Rule 2210(b)(1)(A).

Recordkeeping

NASD Rule 2211(b)(2) requires members to maintain records of institutional sales material for a period of three years from the date of last use, including the name of the person who prepared each such communication. NASD Rules 3010(d)(3)18 and 3110(a)19 require members to retain correspondence of registered representatives as prescribed by Securities Exchange Act Rule 17a-4.

Proposed FINRA Rule 2210(b)(4)(A) specifies that the records for retail and institutional communications would have to include:

- A copy of the communication and the dates of first and (if applicable) last use;
- The name of any registered principal who approved the communication and the date of the approval;
- In the case of a retail communication or institutional communication that is not approved prior to first use by a registered principal, the name of the person who prepared or distributed the communication;
- Information concerning the source of any statistical table, chart, graph or other illustration used in the communication; and
- For retail communications that rely on the exception under proposed FINRA Rule 2210(b)(1)(C), the name of the member that filed the retail communication with FINRA and a copy of FINRA's review letter.

Filing Requirements and Review Procedures

Filing of Initial Communications

Currently, NASD Rule 2210(c)(5)(A) requires a member that has not previously filed advertisements with FINRA or another self-regulatory organization to file its initial advertisement with FINRA at least 10 business days prior to use. This filing requirement continues for a year after the initial filing. Proposed FINRA Rule 2210(c)(1)(A) would trigger the new member one-year filing requirement beginning on the date that the firm's FINRA membership became effective in FINRA's Central Registration Depository, rather than on the date a member first files an advertisement with FINRA.

Filing Requirement for Delinquent Members

NASD Rule 2210(c)(5)(B) currently authorizes FINRA to require a member to file all of its advertisements and/or sales literature, or the portion of the member's material relating to specific types or classes of securities or services, with FINRA at least 10 business days prior to use, if FINRA determines that the member has departed from NASD Rule 2210's standards. Proposed FINRA Rule 2210(c)(1)(B) would carry forward this authority and apply it to all of a member's communications (rather than just advertisements or sales literature).

Pre-use Filings and Clearance

NASD Rule 2210(c)(4) currently requires members to file certain communications at least 10 business days prior to first use and to withhold them from use until any changes specified by FINRA have been made. These communications include advertisements and sales literature for certain registered investment companies that include self-created rankings, advertisements concerning CMOs, and advertisements concerning security futures.

Proposed FINRA Rule 2210(c)(2) would revise the categories of communications that fall within this pre-use filing requirement. These include retail communications concerning any registered investment company that include self-created rankings, retail communications concerning security futures, and retail communications that include bond mutual fund volatility ratings.

The requirement to file retail communications concerning security futures prior to first use would not apply to retail communications that are submitted to another self-regulatory organization having comparable standards pertaining to such communications, and retail communications in which the only reference to security futures is contained in a listing of the services of a member.

Filings Within 10 Days of First Use

Proposed FINRA Rule 2210(c)(3) would revise the categories of communications that must be filed within 10 business days of first use or publication. FINRA Rule 2210(c)(3) would require the following communications to be filed within 10 business days of first use or publication:

- Retail communications concerning registered investment companies and public direct participation programs (including all retail communications concerning closed-end registered investment companies);
- All retail communications concerning government securities;
- Templates for written reports produced by, or retail communications concerning, an investment analysis tool;
- Retail communications concerning CMOs that are registered under the Securities Act of 1933 ("Securities Act"); and
- All retail communications concerning any security that is registered under the Securities Act and that is derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency.

Consistent with current rules, if a member has filed a draft version or "story board" of a television or video retail communication pursuant to a filing requirement, then the member must also file the final filmed version within 10 business days of first use or broadcast.

Content Standards

The Proposal generally follows the content standards of NASD Rule 2210, with a few important differences. Content standards that currently apply to advertisements and sales literature would generally also apply to retail communications.

Promissory Claims

Proposed FINRA Rule 2210(d)(1)(B) would expressly prohibit promissory statements or claims.

Projections

Proposed FINRA Rule 2210(d)(1)(F) would carry forward the current prohibition of performance predictions and projections, as well as the permitted use of hypothetical illustrations of mathematical principles. The Proposal would also clarify that FINRA allows two additional types of projections of performance in communications with the public that are not reflected in the text of NASD Rule 2210(d)(1)(D):

- Projections of performance in reports produced by investment analyst tools that meet the requirements of NASD IM-2210-6 (to be codified under the Proposal as FINRA Rule 2214); and
- Research reports on debt or equity securities, including price targets under certain circumstances.

Price Targets

Proposed FINRA Rule 2210(d)(1)(F) also would clarify that it does not prohibit a price target contained in a research report on debt or equity securities, provided that the price target has a reasonable basis, the report discloses the valuation methods used to determine the price target, and the price target is accompanied by disclosure concerning the risks that may impede achievement of the price target.

Identity of Member

NASD Rule 2210(d)(2)(C) requires all advertisements and sales literature to:

- Prominently disclose the name of the member, and allows a fictional name by which the member is commonly recognized or which is required by any state or jurisdiction;
- Reflect any relationship between the member and any non-member or individual who is also named in the communication; and
- If the communication includes other names, reflect which products and services are offered by the member.

These standards would apply to correspondence as well as to retail communications.

Members would be permitted to use the name under which a member's broker-dealer business is conducted as disclosed on the member's Form BD, as well as a fictional name by which a member is commonly recognized or which is required by any state or jurisdiction.

Disclosure of Tax Aspects of Investments

The Proposal would carry forward the current required disclosures concerning applicable taxes and the current prohibition on communications with the public that characterize income or investment returns as tax-free or exempt from income tax when tax liability is merely postponed or deferred.

Proposed FINRA Rule 2210(d)(4)(C) would add new language concerning comparative illustrations of the mathematical principles of tax-deferred versus taxable compounding. Such illustration:

- Must depict both the taxable investment and the tax deferred investment using identical investment amounts and identical assumed gross investment rates of return, which may not exceed 10 percent per annum;
- Must use and identify actual federal income tax rates;
- Would be permitted (but not required) to reflect an actual state income tax rate, provided that the communication prominently discloses that the illustration is applicable only to investors that reside in the identified state;
- Should refer to tax rates that reasonably reflect those of the target audience as well as the tax character of capital gains and ordinary income;
- Would have to reflect the impact of taxes during this period;

- Could not assume an unreasonable period of tax deferral; and
- Would have to include the following disclosures, as applicable:
  - The degree of risk in the investment's assumed rate of return, including a statement that the assumed rate of return is not guaranteed;
  - The possible effects of investment losses on the relative advantage of the taxable versus tax-deferred investments;
  - The extent to which tax rates on capital gains and dividends would affect the taxable investment's return;
  - Its underlying assumptions;
  - The potential impact resulting from federal or state tax penalties; and
  - That an investor should consider his or her current and anticipated investment horizon and income tax bracket when making an investment decision.

Communications that Contain a Recommendation

Proposed FINRA Rule 2210(d)(7) would revise in several ways the standards currently found in NASD IM-2210-1(6) applicable to communications that contain a recommendation, and extend the application of these standards to retail communications and public appearances.

Currently, NASD IM-2210-1(6)(A) requires disclosure of certain specified conflicts of interest:

- If the member was making a market in the recommended securities or that the member or associated person will sell to or buy from customers on a principal basis;
- If the member and/or its officers or partners have a financial interest in securities of the recommended issuer and the nature of the interest, unless the interest is nominal; and
- If the member was manager or co-manager of a public offering of any securities of the recommended issuer in the past 12 months.

Proposed FINRA Rule 2210(d)(7)(A) would continue the first and third disclosures, but would modify the second disclosure to limit it to financial interests of the member or any associated person with the ability to influence the content of the communication, unless the extent of the financial interest is nominal.

Proposed FINRA Rule 2210(d)(7)(D) would expressly exclude from its coverage communications that meet the definition of "research report" or that are public appearances by a research analyst for purposes of NASD Rule 2711 and that include all of the applicable disclosures required by that rule. Proposed FINRA Rule 2210(d)(7)(D) would also exclude any communication that recommends only registered investment companies or variable insurance products.

Public Appearances

In the interest of simplification, the term "public appearance" is no longer a separate communication category. Nevertheless, proposed FINRA Rule 2210(f) sets forth many of the same general standards that would apply to public appearances that exist currently. Public appearances would have to meet the "fair and balanced" standards of proposed paragraph (d)(1). Unlike the current rules governing public appearances, the disclosure requirements applicable to recommendations in proposed paragraph (d)(7) also would apply if the public appearance included a recommendation of a security. Members would also be required to establish appropriate written policies and procedures to supervise public appearances, and scripts, slides, handouts or other written (including electronic) materials used in connection with public appearances.

Use of Investment Company Rankings in Retail Communications

Proposed FINRA Rule 2212 would replace NASD IM-2210-3 with regard to standards applicable to the use of investment company rankings in communications, with few changes.

FINRA has revised the standards applicable to investment company rankings for more than one class of an investment company with the same portfolio. Such rankings must also be accompanied by prominent disclosure of the fact that the investment companies or classes have different expense structures. The Proposal would add a new paragraph (h) that would exclude from the proposed rule's coverage reprints or excerpts of articles or reports that are excluded from FINRA's filing requirements.

Requirements for the Use of Investment Analysis Tools

Proposed FINRA Rule 2214 would replace NASD IM-2210-6 with regard to standards applicable to the use of investment analysis tools. The standards would generally remain the same with some minor changes.

Review of Investment Analysis Tools

Proposed FINRA Rule 2214(a) would require members to provide FINRA with access to any investment analysis tool and to file any template for written reports produced by, or any retail communication concerning, the tool within 10 business days of first use. This revision makes the access and filing time frame consistent with other filing requirements under proposed FINRA Rule 2210(c).

Supplemental Materials

Under the Proposal, the rule's Supplemental Material would provide:

- A retail communication that contains only an incidental reference to an investment analysis tool would not have to include the disclosures otherwise required for retail communications that advertise an investment analysis tool, and would not have to be filed.
- If a retail communication refers to an investment analysis tool in more detail but does not provide access to the tool or the results generated by the tool, the communication would only have to include the disclosures required by paragraphs (c)(2) and (c)(4) of proposed FINRA Rule 2214.
- Members are required to disclose whether the analysis tool is limited to searching, analyzing or in any way favoring securities in which the member serves as an underwriter.

Communications with the Public Regarding Security Futures

Proposed FINRA Rule 2215 would replace NASD IM-2210-7 with regard to standards applicable to communications concerning security futures and would apply these provisions to all retail communications, not just advertisements.

Proposed FINRA Rule 2215(a)(1) would require members to submit all retail communications concerning security futures to FINRA at least 10 business days prior to first use.

The Proposal would amend the provisions that require communications concerning security futures to be accompanied or preceded by the security futures risk disclosure document under certain circumstances. As revised, a communication concerning security futures would have to be accompanied or preceded by the risk disclosure document if it contains the names of specific securities.

The Proposal would clarify that communications that contain the historical performance of security futures must disclose all relevant costs, which must be reflected in the performance.

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News Bulletin

July 5, 2011

Product Intervention in the UK and the New FCA

Background

As we have previously discussed,[1] the UK Financial Services Authority (the "FSA") signalled a sea change in the way retail financial products will be regulated in the UK in its Discussion Paper[2] on product intervention published in January 2011 (the "Discussion Paper"). In the Discussion Paper, the FSA stated that its existing regulatory approach had not prevented a series of product failures leading to significant customer detriment. It therefore proposed a much more interventionist and intrusive approach to regulation in this area involving earlier regulatory intervention and subjecting firms to greater supervisory and enforcement focus. In its recent Feedback Statement[3] published in June 2011, the FSA provides a summary of the feedback from the 84 responses it received and its proposed next steps.

The FSA is in the process of being broken up and its functions will be transferred to new bodies. In the context of product regulation, most of the relevant functions of the FSA will be transferred to the new Financial Conduct Authority (the "FCA"), which will have responsibility for regulating how firms conduct their business, with the objectives of securing an appropriate degree of protection for consumers, promoting efficiency and choice in the financial services market and protecting and enhancing the integrity of the UK financial system. In June 2011, HM Treasury published a White Paper and accompanying draft Bill[4] setting out the proposed framework for the new regulatory regime. At around the same time, the FSA also published a discussion paper[5] setting out its proposals for the approach to regulation by the FCA and which therefore ties in with the more interventionist approach to product regulation referred to above.

Key Themes of Feedback Statement

The FSA states in the Feedback Statement that consumer organisations were broadly supportive of its proposed new approach, in particular the increased focus on the early stages of product development and marketing. Industry reactions were, however, more diverse. Some of the responses queried the need for increased product intervention, believing that the focus should be at the point of sale and noting that the FSA has already made

[1] See client alert, FSA Product Intervention dated March 14, 2011 - http://www.mofo.com/files/Uploads/Images/110314-FSA-Product-Intervention.pdf.
[2] FSA discussion paper (DP11/1): Product Intervention (25 January 2011), http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf (comments deadline: 21 April 2011).
[3] http://www.fsa.gov.uk/pubs/discussion/fs11_03.pdf.
[4] http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf.
[5] http://www.fsa.gov.uk/pubs/events/fca_approach.pdf.

significant changes to the regulation of retail products in its Retail Distribution Review and Mortgage Market Review aimed at raising standards at the point of sale. Others, however, supported greater intervention.

The FSA makes it clear in the Feedback Statement that, although it agrees that the point of sale is a critical element of regulatory focus and determining where consumer detriment arises, it also believes that product design and decisions about how products will be developed and to whom they will be marketed play an important role in determining consumer outcomes. It states that the regulatory approach will be to look primarily at the product governance processes employed by firms, whether there is effective competition for the benefit of consumers and whether firms are exploiting consumer behaviour. The starting point in relation to product intervention will be not to dictate product structures to the market but to correct problems where competition and the previous regulatory approach have been ineffective in meeting customer needs.

Concerns were raised by respondents as to the interaction of the new approach with regulatory developments in the rest of the EU and the possibility that UK firms could be at a competitive disadvantage if the UK takes a more interventionist, product-based approach than other EU member states. The FSA states that in developing the approach to product intervention, account will be taken of developments at an EU level, particularly the EU Commission review of the Markets in Financial Instruments Directive ("MiFID") and its proposals in relation to packaged retail investment products ("PRIPs"). It also states that it will seek to make changes to EU directives where necessary, in particular to reduce the risk of cross-border arbitrage and products originating outside the UK undermining the effectiveness of the new approach to product regulation. It indicates that it will seek to promote a more interventionist approach at the new European Supervisory Authorities.[6]

The FSA states that it believes the new supervisory focus on products should be supported by a single set of rules and guidance. In this context it envisages that some of the Responsibilities of Providers and Distributors for the Fair Treatment of Customers ("RPPD")[7] guidance be converted into rules. Having a single source of materials available for firms is likely to be helpful and provide greater certainty for providers of financial services. It will not be clear until further details are published, however, exactly how this consolidation will be effected and whether the current principles-based approach in the existing rules and guidance will be maintained.

In relation to its analysis of previous market failures and the need for an approach based on the whole life cycle of a product, the FSA states that it is aware of the difficulties involved in achieving the right balance and accepts it will not always be possible to identify and correct problems before they arise. Where things do go wrong, it is stated that the FCA will be more active in seeking redress. In relation to the question of which products merit an earlier intervention, the FSA had highlighted certain features in the Discussion Paper that might be used as indicators of products for which such approach could be appropriate. These are set out again in annex 2 of the Feedback Statement and include complex products (including bundled products or those with opaque structures), where the product carries an inherent conflict of interest, those products with secondary charges or layers of charges and products where the consumer is attracted by a teaser rate and then tied in. Other criteria were suggested by respondents including where there is evidence of deliberate bad practice, markets where competition works ineffectively and having a greater focus on smaller firms that have fewer resources to deal with problems.

The FSA notes that respondents stressed the importance of reviewing each case on its own merits, that investments inevitably involve risk and that complexity may be necessary for a product to function as expected. Respondents also noted that cross-subsidies are not always inappropriate and do not invariably lead to detriment and that different customers have different needs. The FSA accepts that more work will need to be done by the FCA in calibrating a more risk-based approach, in particular the importance to be put on the scale of detriment and the number of consumers affected. The FSA also stresses in the Feedback Paper that the new approach

[6] The European Banking Authority ("EBA"), the European Securities and Markets Authority ("ESMA") and the European Insurance and Occupational Pensions Authority ("EIOPA").
[7] FSA, 2007/41, http://fsahandbook.info/FSA/handbook/LI/2007/2007_41.pdf.

should be viewed as covering all aspects of product governance including the ongoing management of products (whether new or existing products) and not just product design.

The FSA stresses that it envisages product intervention as being primarily a supervision-led approach at this stage. It does not, however, intend this to replace supervision of other parts of the value chain such as point of sales standards where it believes more action is required. The FSA also states that assessment of firms' business models and strategies will continue to form an important part of the FCA's supervisory approach, which it believes is an important part of ensuring good outcomes for consumers.

Additional Product Intervention Options

The Discussion Paper set out various additional interventions that the FSA envisaged could be considered depending on how far the interventionist approach is pursued. Although many respondents had concerns in relation to some of the proposed approaches, the FSA indicates in the Feedback Statement that the FCA should be prepared to consider deploying all or most of these in appropriate circumstances:

Product preapproval or notification: The Discussion Paper indicated preapproval could be required for a limited number of products. The Feedback Statement reports that around 80% of the respondents commenting on this proposal strongly resisted the concept of preapproval. The FSA states that whilst it continues to rule out general preapproval of products, it does not rule out the possibility that it might be used in the future for certain products or markets. The FSA also states that it does not at this time intend to introduce a pre-notification requirement but, again, does not rule this out in the future.

Banning products or product features and setting minimum standards: The FSA states that respondents were divided on the desirability of outright product bans, although consumer organisations were generally in favour. The FSA states that it continues to believe that banning products or mandating or banning product features and exclusions should be considered where products or product features have the potential to or are causing significant detriment. The FSA also notes that it is currently proposed that the FCA will be given the power to ban products and the EU Commission is also considering the issue of EU-wide product bans.

Price intervention: The FSA had suggested in the Discussion Paper the possibility of focussing on product pricing decisions by firms and the value for money that products offer. It is noted in the Feedback Statement that a number of respondents were in favour of a requirement that firms design products with appropriate charging structures. There was, however, generally disapproval in relation to the introduction of a requirement for firms to consider appropriate overall charges for their products, the introduction of a point of sale responsibility to benchmark advice against a low-charged substitutable product or the introduction of price-capping. The FSA indicates that consideration will continue to be given to introducing requirements for product charges and it considers that interventions over value for money can be useful in certain circumstances to minimise consumer detriment in markets where competition is imperfect.

Increasing the prudential requirement on providers: The Discussion Paper suggested that prudential requirements could be increased for firms designing products likely to lead to detriment to ensure that firms have sufficient capital to deal with complaints and redress. The FSA states that only a minority of those responding agreed with this idea with a number commenting that prudential tools can be blunt instruments when dealing with conduct regulation. The FSA states that it has some sympathy with such an argument and careful consideration should be given to any such proposal before implementation.

Mandated risk warnings: The FSA indicates that many respondents were positive about the idea of consumer and industry warnings about products where deemed to be appropriate. The FSA indicates that it continues to believe such warnings remain an option, although they should be used sparingly and their use should be supported by evidence.

Prevention of non-advised sales or limiting product sales to certain types of customer: The FSA notes in the Feedback Statement that most respondents were opposed to the prevention of non-advised sales or limiting sales to certain types of customer. The FSA believes, however, the option should still be available where the FCA identifies particularly vulnerable consumers or particular circumstances in which a prevention of non-advised sales is the most likely route to improving customer outcomes.

Overall Approach of the FCA

When the FCA is established, its strategic objective will be to protect and enhance confidence in the UK financial system. The White Paper published in June 2011 outlines in more detail the regulatory approach to be taken by it. The FCA will have three operational objectives:

- Securing an appropriate degree of protection for consumers
- Promoting efficiency and choice in the market for financial services
- Protecting and enhancing the integrity of the UK financial systems

The FCA will also be required to discharge its functions in a way that promotes competition and to have regard for six regulatory principles including proportionality of burdens or restrictions related to benefits, the general principle that consumers that should take responsibility for their decisions, and openness and disclosure of relevant information.

Under the draft bill contained in the White Paper, the FCA will have a wide power to make general rules prohibiting or restricting authorised persons from entering into agreements that might have the effect of exposing consumers to an economic interest in specified products. These powers are therefore likely to assist it in adopting a more interventionist approach to product regulation.

The FSA discussion paper relating to the approach to regulation of the FCA is consistent with the Discussion Paper and the Feedback Statement, stating the FCA will be ready to intervene and make full use of its powers to tackle potential and emerging risks to consumer protection and market integrity before they materialise to prevent large-scale detriment. It states that the FCA will intervene early in relation to products where the risks are likely to outweigh the benefits and will give consideration to factors such as the number of consumers and the amount of their potential loss. It also notes that the FCA will seek to base its regulatory interventions on a deeper understanding of underlying commercial and behavioural drivers and the causes of poor outcomes for consumers.

Next Steps

The FSA indicates in the Feedback Statement that changes need to be made to the regulatory approach to consider the entire life cycle of a product including product governance and distribution standards. As indicated above, it intends that a single set of rules and guidance be published on product governance including turning some or all of the Treating Customers Fairly materials into rules. It also notes that it will continue to monitor the various EU proposals impacting on retail products and will seek changes to directives where necessary. The transfer of the FSA's relevant functions to the FCA will of course have an impact on the nature of financial regulation in the UK even though many of the relevant personnel will remain the same. As stated above, it seems that the FCA will have additional powers to intervene at an early stage, which therefore complements the proposed new interventionist approach. The FSA states that the timetable to be adopted for the introduction of new rules and additional interventions will reflect the outcome of the legislative process in both the UK and the EU.

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Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

The SEC's Proposed Amendments to Regulation M: Potential Impact on Structured Notes

Introduction

Section 939A of the Dodd-Frank Act requires the SEC to review (i) any regulation that requires the use of an assessment of the creditworthiness of a security and (ii) any reference to or requirement in such regulations regarding credit ratings, and to modify them to remove those references and substitute standards of creditworthiness the SEC determines to be appropriate.[1] The SEC's proposed amendments to Regulation M, announced during the second quarter of 2011, would remove the references to credit ratings in Rules 101(c)(2) and 102(d)(2) of Regulation M, and replace them with new standards relating to the trading characteristics of covered securities.

In this article, we discuss the potential impact of these amendments on the structured notes market. In its proposing release,[2] the SEC stated that it intended generally to except from Regulation M the same types and amounts of securities that are currently excepted in Rules 101(c)(2) and 102(d)(2), without referencing credit ratings. However, the approach outlined in the proposed rules does not appear likely to satisfy this goal as to structured note issuances.

[1] Dodd-Frank Act, § 939A(a)(1)-(2) and (b).
[2] Available at: http://www.sec.gov/rules/proposed/2011/34-64352.pdf.

Proposed Amendments to Rules 101 and 102 of Regulation M

Regulation M prohibits activities that could artificially influence the market for a "covered security."[3] Rules 101 and 102 of Regulation M prohibit issuers, underwriters, other distribution participants, and any of their affiliated purchasers, from directly or indirectly bidding for, purchasing, or attempting to induce another person to bid for or purchase a covered security during the applicable restricted period. Rules 101(c)(2) and 102(d)(2) except from their respective provisions "investment grade nonconvertible and asset-backed securities,"[4] which are nonconvertible debt securities (as well as nonconvertible preferred securities and asset-backed securities) that are rated by at least one nationally recognized statistical rating organization in one of its generic rating categories that signifies investment grade.[5] This category, nonconvertible debt securities, has been generally deemed to include most structured notes issued by financial company issuers that have an investment grade rating for their senior debt securities, other than structured notes that are exchangeable for another type of security, such as, for example, "reverse convertible securities."

We have summarized the proposed amendments in our recent news bulletin (available at: http://www.mofo.com/files/Uploads/Images/110524-Regulation-M.pdf). However, we repeat here some of the key provisions, in order to indicate how they could apply to structured notes.

The SEC's proposed amendments would replace the references to credit ratings in Rules 101(c)(2) and 101(d)(2) with new standards relating to trading characteristics of investment grade nonconvertible debt securities. Those securities will be excepted from Rules 101 and 102 if they:

1) are liquid relative to the market for that asset class;

2) trade in relation to general market interest rates and yield spreads; and

3) are relatively fungible with securities of similar characteristics and interest rate yield spreads.

As described in more detail below, a wide variety of structured notes are not likely to fit within these standards.

Proposed New Standards

Liquid Relative to the Market for that Asset Class

To determine whether nonconvertible debt securities are liquid relative to the market for their respective asset class, the following factors could be considered:

- the size of the issuance;
- the percentage of the average daily trading volume by persons other than the persons seeking to rely on the exception;
- the number of market makers in the security being distributed other than the persons seeking to rely on the exception;
- the overall trading volume of the security;
- the number of liquidity providers who participate in the market for the security;
- the trading volume in similar securities or other securities of the same issuer;

[3] 17 C.F.R. §§ 242.101 et. seq. (March 4, 1997). The term "covered security" includes most types of securities that are subject to a distribution, unless otherwise excepted by Regulation M.
[4] Regulation M, §§ 242.101(c)(2) and 242.102(d)(2).
[5] *Id*.

- the overall liquidity of all outstanding debt issued by the same issuer; and
- how quickly an investor could be expected to sell the security after purchase.

The list of proposed factors is illustrative and the SEC does not intend it to be exhaustive or mutually exclusive. However, most structured note issuances are likely not to satisfy these standards. The small aggregate principal amount of many issuances, the limited number of marketmakers for them, and their limited liquidity are likely to be barriers for most issuances to qualify, even if they are listed on a securities exchange.

Trade in Relation to General Market Interest Rates and Yield Spreads

Nonconvertible debt securities would need to trade at prices that are primarily driven by general market interest rates and spreads applicable to a broad range of similar securities to qualify for the proposed exception. As a result, the exception is limited to securities that trade in relation to changes in broader interest rates (based on their comparable yield spreads), and securities that trade in relation to issuer-specific information or credit quality would not qualify. The SEC also noted that it would be more difficult for market participants to determine that a security trades in relation to changes in broader interest rates if it trades in an idiosyncratic fashion based primarily on its specific characteristics, such that the traded price could not readily be compared to similar issues. This standard will eliminate many types of structured notes from the exemption provided from Rule 101 and Rule 102, in light of the customized terms of most structured products.

Relatively Fungible with Securities of Similar Characteristics and Interest Rate Yield Spreads

In order for a security to be relatively fungible (in terms of trading characteristics) under the proposed amendments, a portfolio manager would be willing to purchase it in lieu of another security with similar characteristics, such as yield spreads and credit risk.[6] As to this standard, the unique characteristics and terms of different types of structured notes would seem to disqualify many or most of them from this test.

Evaluation Under the Proposed Standards

An issuer or underwriter seeking to rely on the new exception must determine that the specific nonconvertible debt security being distributed meets the proposed standards using reasonable factors. These entities would be required to exercise reasonable judgment in conducting their analysis, and the determination must be subsequently verified by an independent third party.[7] However, sole reliance on a third party's determination, without any further analysis, would not be considered to be based on reasonable judgment. Persons seeking to rely on the exception must demonstrate compliance with the requirements of the proposed amendments.

Accordingly, if adopted, these proposals will require significant changes in the operations of underwriters and other distribution participants. Such changes, including the retention of an independent third party, would likely add significant cost to each issuance, making a variety of potential offerings less attractive to the offerors, even assuming that the relevant issuances could satisfy the new standards.

Potential Impact

Assuming that a particular structured note issuance would not satisfy the new standards for exclusion from Regulation M, the marketing and trading of such issuances could change in a number of ways. These changes would arise from Rule 101's and Rule 102's prohibition of bidding for, purchasing, or attempting to induce any person to bid for or purchase, a covered security.

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[6] However, the security need not be deliverable for a purchase order for a different security and it need not be completely fungible for all purposes with another security with similar characteristics in order to satisfy this standard.
[7] An affiliate of an issuer or the underwriter, or counsel to these parties, would not satisfy the independence standards.

Reopenings and Multiple Tranches. A variety of structured note issuances are (a) “reopened” with an additional principal amount of fully fungible securities after the closing date or (b) priced on multiple days prior to their initial closing. For example, in the case of (b), an issuer could agree on successive business days to offer different principal amounts of the same series of notes to different investors, and to close these offerings on the same closing date.

In these cases, the issuer and the underwriter would be barred by the proposed new rules from posting bids or quotes on the initially offered securities until the distribution of that series has been completed. Because the initial offering of the relevant notes would typically not qualify for the exemption from the definition of “covered securities,” issuers and underwriters would be limited in terms of their ability to make a market.

Variable Price Reofferings. In variable price reofferings, underwriters typically offer the relevant securities for several days or several weeks, at offering prices that vary based on prevailing market prices. In this context as well, the brokers participating in the distribution would have a limited ability to make a market for the securities that investors previously agreed to purchase, until the termination of the variable price reoffer.

Length of Restricted Period. Rule 100’s definition of “restricted period” would not be affected directly by the proposed amendments. However, because many structured notes would no longer be exempted from Regulation M, the parties to an offering would need to consider whether Rule 100’s (a) five-business-day or (b) one-business-day restricted period would apply. As a practical matter, the five-business-day period would generally apply, so that the restricted period for most issuances would generally begin five-business-days prior to the determination of the offering price. This is because most structured notes would not qualify for the shorter restricted period of one business day — they would not satisfy Rule 100’s requirement of having an average daily trading volume of at least $100,000. As a result, in the case of a reopening, a broker would generally need to cease its market-making activities at least five business days prior to the time at which it proposed to commence the offering of the issuance to be reopened.

Unsolicited Transactions. These potential restrictions would not fully eliminate the ability of a broker to agree to repurchase structured notes that were otherwise subject to Regulation M. Issuers and broker-dealers would retain the exemption for “unsolicited transactions” that are contained in existing Rule 101 and Rule 102. For example, if a customer sought to sell back to a broker a structured note that was subject to a variable price reoffer or a reopening, it could reach out to the broker to propose the repurchase.

Request for Comments

The SEC seeks public comment on the proposed rules by July 5, 2011. In addition to comments on the proposed standards, the SEC is interested in whether and in what circumstances issuers, selling security holders, distribution participants, and their affiliated purchasers rely on the current exception for investment grade securities, including with respect to specific activities, and whether it serves a continuing purpose with respect to nonconvertible debt. The SEC is also soliciting comments as to whether the current investment grade exception should be eliminated or, alternatively, whether it should be expanded to except from Rules 101 and 102 all nonconvertible debt, nonconvertible preferred, and asset-backed securities (or some subset of those types of securities). The SEC seeks comments generally on any relevant changes to the debt markets since Regulation M’s adoption in 1996 and how those developments should affect the SEC’s evaluation of the proposed amendments. In light of the emergence of the structured note market since that time, and the impact of the proposals on this market, we anticipate that a variety of comments will address the unintended consequences of the proposed amendments on this market.

Update on FINRA Know Your Customer and Suitability Compliance

New Effective Date: July 9, 2012

On May 18, 2011, FINRA announced in Regulatory Notice 11-25 that it is extending the implementation date for compliance with FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability). The new effective date is July 9, 2012. The notice may be found at: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123701.pdf.

This new date gives firms a nine-month extension to modify their procedures, implement policy changes, and educate associated persons to comply with the new rules. The original effective date was October 7, 2011. The provisions of FINRA Rule 2090 and Rule 2111 may be found at: Regulatory Notice 11-02, http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf.

New FINRA Guidance for Rule 2090 and Rule 2111

In addition to announcing a new effective date, Regulatory Notice 11-25 provides guidance to frequently asked questions about the new rules. However, note that existing guidance and interpretations of Rule 2090 and Rule 2111 continue to apply to the extent that they are not inconsistent with the new rules.

We previously described the provisions of FINRA Rule 2090 and Rule 2111 in Volume 1, Issue 13 of Structured Thoughts (available at: http://www.mofo.com/files/Uploads/Images/101004-Structured-Thoughts-Issue-13.pdf), as well as FINRA's announcement of the original effective date of the rules in Volume 2, Issue 1 of Structured Thoughts (available at: http://www.mofo.com/files/Uploads/Images/110120-Structured-Thoughts.pdf). However, we repeat here some of the key provisions, in order to indicate how some of the new guidance applies.

Rule 2090 (Know Your Customer)

Rule 2090 requires firms to "use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer…"[8] Essential facts are "those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."[9]

Regulatory Notice 11-25 clarifies that the obligation under subsection (c) to "understand the authority of each person acting on behalf of the customer" requires the firm to know both (a) the names of any authorized persons and (b) any limits on their authority that the customer establishes and communicates to the firm.[10]

Rule 2111 (Suitability)

Rule 2111 requires that a firm or associated person "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the

[8] FINRA Rule 2090, Regulatory Notice 11-02 (Jan. 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf.
[9] *Id.*
[10] Regulatory Notice 11-25, page 2.

information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile."[11]

This profile includes, but is not limited to, "the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information that the customer may disclose to the member or associated person in connection with such recommendation."[12]

The Customer's Investment Profile

A firm must attempt to obtain and analyze relevant customer-specific information, but may use its own appropriate method or process to obtain it. Rule 2111 does not include explicit documentation requirements. In order to fulfill the general obligation to evidence compliance with FINRA rules, the firm may document suitability depending on the complexity, strategy, performance, and/or risks involved.[13]

- If a firm has not obtained all of the customer-specific information listed in Rule 2111 (age, investments, financial situation, tax status, investment objectives, investment experience, time horizon, liquidity needs, and risk tolerance, etc.), it must carefully consider whether it has sufficient understanding of the customer to properly evaluate suitability.[14]
- If a firm allows a customer to use different investment profiles or factors for different accounts, it cannot use factors from different accounts to justify a recommendation that is not appropriate for the account for which the recommendation is made.[15]

Strategies

The term "strategy" is interpreted broadly. Rule 2111 would cover a recommended investment strategy regardless of whether the recommendation results in a securities transaction. The more complex and risky the strategy is, the more the firm using a risk-based approach should focus on the recommendation.[16]

Rule 2111 would also capture an explicit recommendation to hold a security or securities. However, a hold recommendation would not create an ongoing duty to monitor and make subsequent recommendations absent an agreement that might alter the normal broker-customer relationship.[17]

"Safe-Harbor" Provision in Supplementary Material

Rule 2111 exempts certain educational material as long as the material does not include a recommendation of a particular security or securities.[18] However, the provision is limited in scope.

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[11] FINRA Rule 2111, Regulatory Notice 11-02 (Jan. 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf.
[12] *Id.*
[13] Regulatory Notice 11-25, page 3.
[14] *Id.*
[15] Regulatory Notice 11-25, page 5. For example, a customer may utilize one account to hold fixed income securities and "principal protected" structured products, and a second account to hold securities that are more likely to result in loss of principal.
[16] Regulatory Notice 11-25, page 6.
[17] *Id.*
[18] FINRA Rule 2111, Supplementary Material .03.

FINRA recommends that firms take a conservative approach when seeking to rely on Rule 2111 for strategy-related communications that are educational in nature, because any significant variation from the list in the provision (such as general and interactive financial and investment information, descriptive information about an employer-sponsored retirement or benefit plan, asset allocation models) is subject to regulatory scrutiny. However, it is important to note that the rule does not apply if a reasonable person would not view the communication as a recommendation. This means that the suitability rule covers the firm's recommendation to a customer, but generally not a firm's marketing brochure that explains risks and benefits without suggesting that the reader customer take action.

This safe harbor is likely to be relevant to offerings of structured products. For example, issuers and underwriters often distribute free writing prospectuses that describe products or strategies to customers. Given that the safe harbor is limited, issuers and underwriters should continue to review free writing prospectuses to ensure that they are not appearing to make a recommendation.

Reasonable-Basis Obligation

The reasonable-basis obligation provision has two main components. A broker must 1) perform reasonable diligence to understand the risks and rewards associated with the strategy and 2) determine whether the recommendation is suitable for at least some investors based on that understanding.[19] A broker can violate reasonable-basis suitability if either of the two elements is missing. Therefore, even if a firm's "product committee" has approved a product for sale after performing due diligence, an individual broker's lack of understanding could still violate the reasonable-basis obligation.[20]

* * *

For additional information, please refer to FINRA Regulatory Notice 11-25, linked above.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

[19] FINRA Rule 2111.
[20] Regulatory Notice 11-25, page 8.

Morrison & Foerster News Bulletin
Volume 2, Issue 5 June 2, 2011

Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Principal Protected Note Tutorial from SEC and FINRA

The SEC's Office of Investor Education and Advocacy teamed up with FINRA to publish an alert on principal protected notes titled "Structured Notes with Principal Protection: Note the Terms of Your Investment" on the SEC's website at http://www.sec.gov/investor/alerts/structurednotes.htm.

The alert notes the growth in the structured products market and comments on the proliferation of products with different names and cautions investors to educate themselves regarding the risks inherent in principal protected products. It focuses on credit risk and on the limited secondary market and notes that principal protected products "have the potential to outperform the total interest payment that would be paid on typical fixed interest rate bonds." However, the alert also warns against hidden fees. Overall, the alert should prove helpful to investors, but the presentation of fees may be more confusing than helpful and may serve as another indication that additional clarity on fee disclosures—from the basic notion of spreads and selling concessions, to the more complex notion of structuring fees—would benefit the market.

FINRA Priorities

At FINRA's Annual Conference, Richard Ketchum made wide-ranging comments and spoke about structured products. Here is an excerpt of his speech:

> The increasing availability of complex and sophisticated products to retail investors, while beneficial in some ways, can present challenges to a compliance department. Investors can trade exchange-traded products that provide the ability to speculate on the volatility of the securities markets or the spread between various asset classes. The structured retail products market has grown in the last few years: Over 8,000 retail structured products were sold in 2010.
>
> The breathtaking pace of innovation and availability of these more sophisticated and complex products pose significant challenges to firms. A solid understanding of an investment product is at the core of suitability analysis and sound sales practices. I am pleased to hear that many firms are taking this challenge extremely seriously and enhancing their product training programs.
>
> I am also pleased that some firms are establishing new control measures around their distribution processes. At the outset, firms should determine which products they are comfortable allowing their reps to sell to retail customers. Many firms have established new product committees to vet new products and determine which ones they will prohibit. The best review programs are dynamic, and require that the firm monitor market and economic conditions that could change the firm's view about the appropriateness or suitability of a particular product.
>
> Some firms have even established additional controls with respect to those complex products they do permit. Some firms require retail customers who are interested in purchasing these complex products to complete an option account approval process. Some firms also prequalify retail customers and require them to sign specialized investor qualification agreements. These agreements may explain product features and risks in plain English, and require customers to attest to having read the materials provided, understanding the risks and wanting to invest in the product.
>
> The challenges posed by the growth of these products affect our regulatory programs as well. FINRA monitors product development for many of the same risk factors considered by firms. We look at the complexity of products, and assess the likelihood that investors and registered representatives will understand and appreciate the risks they present. We look at the transparency of key components of products, such as embedded leverage, optionality, counterparty risks, and fees and expenses that raise concerns.
>
> This analysis helps us better understand where emerging risks may arise and identify opportunities to provide guidance to firms and educational materials to investors. You can learn more about new and complex products from the panel later this morning.
>
> Effective supervision is rooted in a thorough understanding of the product risks, coupled with robust broker training regarding the clients for whom the product is appropriate. Brokers cannot rely on firm approval alone to satisfy their suitability obligations. This is particularly important with the proliferation of increasingly complex financial products, and at a time when certain investors are tempted to chase yield in today's low interest rate environment.

Ketchum's comments echo the themes included in many of FINRA's recent Notices to Members as well as in FINRA's statements relating to enforcement actions in the structured products area, including the focus on suitability, new product approval processes, training, plain English disclosures that are fair and balanced, and effective supervision.

Why So Many Opinions? Exhibit 5.1 Opinions

The SEC rules and guidance require an unqualified "validity opinion" (an exhibit 5.1 opinion delivered by issuer's counsel) to be filed by the issuer in connection with each registered shelf takedown, including, for frequent issuers, takedowns conducted pursuant to a medium-term note program or other continuous offering program. The SEC's interpretation on this is in its Compliance and Disclosure Interpretation:

Question 212.05

Question: Can a registration statement under Rule 415 be declared effective without an opinion of counsel as to the legality of the securities being issued when no immediate sales are contemplated?

Answer: No. However, when sales are not expected in the near future, the registrant may file a qualified opinion of counsel and have its registration statement be declared effective, subject to the understanding that an unqualified opinion will be filed no later than the closing date of the offering of the securities covered by the registration statement. An updated opinion of counsel with respect to the legality of the securities being offered may be filed in a Form 8-K report rather than a post-effective amendment to a Form S-3 shelf registration statement. This position is limited to opinions of counsel regarding the legality of the securities being offered, which are required to be filed in connection with shelf takedowns. [Aug. 14, 2009]

Historically, counsel working with issuers that used their shelf registration statements in connection with proposed sales on a delayed basis of various types of securities or in connection with medium-term note programs, filed qualified 5.1 opinions at the time of the shelf filing. For frequent issuers, some of which have almost daily takedowns of securities, the above-referenced Staff guidance had largely been observed in the breach.

However, the SEC recently contacted a variety of large frequent issuers to request stricter adherence to this stated policy. Accordingly, for example, if you search recent EDGAR filings for large frequent issuers, you will find frequent Form 8-K/6-K filings containing the relevant validity opinions. Some issuers have taken the approach of filing a legal opinion with the SEC under cover of a Form 8-K containing the proper disclosures and subsequently including in each pricing supplement the unqualified validity opinion.

Issuers will need to make certain that the correct corporate and related diligence procedures are being followed in connection with rendering validity opinions frequently.

Principles Applicable to Retail Structured Products Reaffirmed

The Joint Associations Committee on Retail Structured Products recently republished principles for managing the provider-distributor relationship (PD Principles) in retail structured products and principles for managing the distributor-individual investor relationship (DI Principles). The PD Principles and DI Principles were originally published in July 2007 and July 2008, respectively. The Principles may be accessed at http://www2.isda.org/asset-classes/structured-products/. The Principles address many issues frequently encountered by issuers and distributors of structured products. Although the Principles were originally drafted prior to the financial crisis, they remain relevant to market participants today.

Summary of Key Issues from Recent FINRA Fines

Introduction

FINRA's April 2011 announcements of its actions against two broker-dealers[1] received substantial attention in the structured products industry. In particular, these actions provide useful guidance as to the types of issues that are of most concern to FINRA in connection with its review of the structured products sales process.

This article attempts to summarize the core issues presented in these two cases. The tables below describe the key issues that FINRA identified, and may be used to assist broker-dealers in their review of FINRA's actions and whether they provide guidance for their operations. In some situations, changes or improvements may be advisable.

FINRA Rules and Guidance	Practice at Issue	Potential Items to Review
New Product Review (Notice to Members 05-26)	No process to review or approve any particular product prior to offering. (Santander Consent, page 4.) Offerings of structured products issued by mutual funds were not presented to the new product committee. (Santander Consent, page 7.)	Confirm that an appropriate new product approval process exists, is used, and is determined to be effective.
Suitability (NASD Rule 2110)	Insufficient suitability guidance for the sales force. No specific limits; no guidance or recommendations as to which clients were appropriate. No guidelines as to appropriate levels of concentration in structured products. Identification of specific unsuitable sales which resulted in customer losses. (UBS Consent, page 4; Santander Consent, pages 4-6.)	Ensure that appropriate suitability guidelines exist for the sale of structured products, including limitations on their purchase and concentration of products in a particular investor's account.
Supervision of Sales (NASD Rule 3010)	Inadequate training, guidance and supervision of structured product sales. (UBS Consent, pages 3 and 7; Santander Consent, page 4.) No guidance or tools for managers to use to determine suitability, and no tools to identify concentration in an investor's	Review policies and procedures for sales of structured products. Not only is the policy itself relevant, but the effectiveness of the policy in practice remains relevant.

[1] The UBS consent (the "UBS Consent") may be found at: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123478.pdf. Our summary of the UBS Consent may be found in *Structured Thoughts*, Volume 2, Issue 4: http://www.mofo.com/files/Uploads/Images/110414-Structured-Thoughts.pdf. The Santander consent (the "Santander Consent") may be found at: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123490.pdf.

FINRA Rules and Guidance	Practice at Issue	Potential Items to Review
	account. (Santander Consent, page 5.) Systems for manager to conduct suitability review were viewed as slow, inefficient and impractical. (Santander Consent, page 5.) Failure to adequately address accounts identified as concentrated in a particular reverse convertible. (Santander Consent, page 5.) Failure to supervise pledge collateral accounts. No policies to govern how recommendations to purchase using these accounts would be monitored. (Santander Consent, pages 6-7.) Mutual fund products sold to accredited investors without a procedure to ensure that investors received offering documents, or properly executed representation letters. Practice resulted in sales to non-accredited investors, and who were not resident in an appropriate jurisdiction. (Santander Consent, page 7.)	Ensure that account opening procedures are being observed, and required questionnaires and agreements are being obtained.
Offering Documents (NASD Rule 2110)	Offering materials provided to investors that were allegedly misleading about the nature of “principal protection.” (UBS Consent, page 5.) Offering materials not updated to reflect increasing UBS credit risk. (UBS Consent, page 6.) Mutual fund structured products sold to investors without first providing offering and disclosure documents. (Santander Consent, page 7.) Pricing supplements provided to investors that incorrectly identify the relevant issuer. (Santander Consent, page 7.)	Review of informational materials provided to clients, as well as “internal-only” materials, for accuracy and fairness. Ensure proper mechanism exists for delivery of key offering documents to investors prior to their investment decision.
Training	No required training on structured products for brokers or supervisors. (UBS Consent, page 3; Santander Consent, page 4.) Incorrect explanatory materials provided to the sales force. Sales force misunderstood the terms of the securities. UBS Consent, page 5; Santander Consent, page 4.	Mandate appropriate structured product training and understanding of relevant products prior to permitting personnel to effect sales.

FINRA Rules and Guidance	Practice at Issue	Potential Items to Review
Corporate Financing Rule (FINRA Rule 5110, formerly NASD Rule 2710) Conflicts of Interest (FINRA Rule 5121, formerly NASD Rule 2720)	Public offerings without prior filings under the Corporate Financing Rule. (Santander Consent, page 8.) Offerings involving a conflict of interest did not satisfy the necessary requirements, and Santander did not make customer-specific suitability determinations. (Santander consent, page 9.)	Review offering procedures to ensure proper filings with FINRA are made (or that an exemption from filing exists). Review procedures for offerings involving conflicts of interest.

A number of common themes emerge from the UBS Consent and the Santander Consent. In each case, FINRA reminded broker-dealers of the need for appropriate supervisory procedures, and potentially for more rigorous suitability determinations. As alleged mis-sales of structured products continue to receive attention in the mainstream press, it is possible that additional FINRA actions of this nature may arise.

Upcoming Teleconference: Regulatory Initiatives Affecting Structured Products

Morrison & Foerster London partners will lead a teleconference on July 27, 2011, beginning at 11:00 a.m. EDT, to discuss regulatory initiatives affecting structured products. Investors continue to find structured products to be attractive investments. Growth in the structured products market and renewed focus on investor protection issues has led to increased regulatory scrutiny. Speakers will discuss key regulatory developments that may affect the U.S. and the EU markets for structured products, including FINRA guidance in the U.S. relating to structured products; know-your-customer; suitability and fiduciary duty issues; disclosure considerations; the potential impact of the Dodd-Frank Act on structured products; the importance of the Key Information Document; the EU Packaged Retail Investment Products (PRIPs) initiative; the FSA's Product Intervention paper in the UK; and other emerging issues.

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News Bulletin

May 5, 2011

Proposed Amendment to FINRA Rule 5131

On April 18, 2011, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed a proposed rule change with the Securities and Exchange Commission ("SEC") which proposes to amend paragraphs (b) and (d)(4) of FINRA Rule 5131 (the "Amendment").[1] The proposed changes amend the spinning provisions (Rule 5131(b)) and the market order provisions (Rule 5131(d)(4)). In addition, the Amendment proposes delaying the effective date for the spinning provisions and the market order provisions to September 26, 2011, an additional four months. On April 26, 2011, the SEC released a notice regarding the rule change and solicited comments from the public.[2] Comments are due on or prior to the date that is 15 days from the publication of the notice in the Federal Register. The SEC declared that, within 45 days of the date of publication of the notice in the Federal Register or within such longer period (i) as the SEC may designate (up to 90 days of such date if the SEC finds such longer period to be appropriate and publishes its reasons for so finding) or (ii) as to which FINRA consents, the SEC will either approve or disapprove the proposed rule change or institute proceedings to determine whether the proposed rule change should be disapproved. The SEC also noted that it is considering granting accelerated approval of the proposed rule change at the end of a 15-day comment period.

Adopting Rule 5131 has been on the agenda for some time. In 2002, the National Association of Securities Dealers, Inc., the predecessor to FINRA, proposed Rule 2712 to address alleged abuses in the allocation and distribution of securities in initial public offerings ("IPOs"). On September 29, 2010, the SEC approved FINRA Rule 5131, on an accelerated basis, and solicited comments on the proposed final rule.[3] The approved version of Rule 5131 represented the fourth amendment of the original rule proposal. For a detailed discussion of Rule 5131 and its regulatory history, consult our recent Client Alert "Spinning: FINRA Rule 5131." In November 2010, FINRA issued Regulatory Notice 10-60 announcing that the SEC had approved Rule 5131 and that it would go into effect on May 27, 2011.[4]

The first change proposed by FINRA in the Amendment relates to the prohibition on spinning. Spinning refers to the practice by certain underwriters of allocating "hot" IPO shares to directors and/or executives of potential investment banking clients in exchange for investment banking business. As approved in November 2010, Rules 5131(b)(2) and (3) prohibit the allocation of new issue shares to any account in which an executive officer or director of a public company or covered non-public company, or a person materially supported by such executive

[1] See http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p123521.pdf.
[2] See "Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change to Amend FINRA Rule 5131 (New Issue Allocations and Distributions)," on SEC website, http://www.sec.gov/rules/sro/finra/2011/34-64341.pdf.
[3] See "Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 4 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment Nos. 1 through 4, Relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in Initial Public Offerings," on SEC website, http://www.sec.gov/rules/sro/nasd/2010/34-63010.pdf.
[4] See "Regulatory Notice 10-60: SEC Approves New FINRA Rule to Address Abuses in the Allocation and Distribution of New Issues," on FINRA website, http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122490.pdf.

officer or director, has a beneficial interest: (1) if the company is currently an investment banking services client of the member or the member has received compensation from the company for investment banking services in the past 12 months; (2) if the person responsible for making the allocation decision knows or has reason to know that the member intends to provide, or expects to be retained by the company for, investment banking services within the next three months; or (3) on the express or implied condition that such executive officer or director, on behalf of the company, will retain the member for the performance of future investment banking services. There are certain exceptions to the spinning prohibition.

Paragraph (b)(1) of the rule requires that member firms maintain and enforce policies and procedures reasonably designed to ensure that investment banking personnel have no involvement or influence, directly or indirectly, in the new issue allocation decisions of a member.[5] When proposed in September 2010, FINRA noted that while establishing such policies had become customary, it wanted to ensure that such policies and procedures remain in force at member firms. However, the term investment banking personnel is not defined in the rule. According to FINRA, member firms have noted their concern that if the term is read together with the definition of investment banking services, Rule 5131(b)(1) would prohibit certain essential functions traditionally performed by syndicate personnel. As this was not the intended consequence, FINRA is proposing to delete all of clause (b)(1). FINRA noted that it believes that the benefits of the anti-spinning provisions can be obtained without clause (b)(1) since NASD Rule 3010(b)(2) requires that member firms establish written policies and procedures with respect to spinning prohibitions. No other changes to Rule 5131(b) have been proposed other than the deletion of clause (b)(1).

The Amendment also proposes that the implementation date of amended Rule 5131(b) be postponed until September 26, 2011. In the amended rule proposal, FINRA noted member firms' concerns with being able to comply with the new spinning rules in such a short time frame. Compliance measures described by FINRA include the preparation of additional forms and account documents, and other methods of collecting information from clients; building systems and surveillance infrastructure to ensure appropriate blocks of allocations; and developing proper compliance policies and procedures, and training materials on the new policies and procedures.[6]

The second change proposed by FINRA in the Amendment relates to market orders. Rule 5131(d)(4) as approved in November 2010 provides that no FINRA member may accept a market order for the purchase of shares of a new issue in the secondary market prior to the commencement of trading of the shares in the secondary market. According to FINRA, member firms have requested additional time prior to the effectiveness of this provision to develop processes for identifying shares of a new issue and to modify their order handling systems to prevent the acceptance of market orders in new issue shares in contravention of this new rule.[7] FINRA proposed that the effectiveness of Rule 5131(d)(4) be postponed until September 26, 2011.

FINRA stated in the amended rule proposal that it believes the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Securities Exchange Act of 1934 which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.[8] According to FINRA, it believes the proposed rule change simplifies member obligations with respect to Rule 5131, thereby aiding member compliance efforts and helping to maintain investor confidence in the capital markets.[9] The Amendment does not represent significant changes to the current version of the rule. Member firms and other market participants that have commenced preparing their Rule 5131 compliance efforts need not change their efforts.

[5] See id.
[6] See id., n. 5.
[7] See id.
[8] See id.
[9] See id.

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News Bulletin

17 February 2011

European Resolution and Recovery Framework for Financial Institutions

On 6 January 2011, the European Commission (the "Commission") published a consultation paper on the technical details of a possible EU framework for bank recovery and resolution (the "Consultation Paper").[1] The paper follows the communication from the Commission dated 20 October 2010 on an EU framework for crisis management in the financial sector (the "Communication").[2]

The need for jurisdictions to ensure they have adequate frameworks to deal with failing institutions at an early stage, in particular to address some of the "moral hazard" issues arising in relation to institutions regarded as "too big to fail," has been a key issue in the international response to the financial crisis. The G-20 leaders' summit in Seoul in November 2010 endorsed the Financial Stability Board's proposals in its report on reducing the moral hazard risk posed by systemically important financial institutions, dated 20 October 2010. The Basel Committee on Banking Supervision ("BCBS") also published a report and recommendations in relation to cross-border resolution issues in March 2010,[3] and its October 2010 report to the G-20 noted it had discussed conducting an evaluation of different legal and policy changes to assist authorities in addressing future needs for crisis management and resolution of financial institutions. The BCBS is continuing a review assessing the systemic importance of financial institutions at global level and a review on going concern loss absorbency that could be provided by financial instruments. Its proposals are likely to be published during 2011 and will inevitably have an impact on the EU Commission's proposals as set out in the Consultation Paper.

Some jurisdictions have already taken steps to introduce recovery and resolution regimes for banks and other financial institutions. In the United Kingdom, the Banking Act 2009 introduced a special resolution regime giving various powers to the UK financial authorities to intervene prior to the insolvency of a failing bank or other deposit taking institution. These included facilitating a private sector rescue of the bank, transferring all or part of the bank's business to a state controlled bridge bank as a temporary measure or bringing the bank into full temporary public ownership. The Financial Services Act 2010 also introduced various measures, including requiring the Financial Services Authority to require certain firms to develop and maintain recovery and resolution plans (or "living wills"). Most recently, the UK has introduced a special administration regime for investment banks, to address a number of issues that arose in connection with the administration of Lehman Brothers International Europe in the UK, in particular aiming to assist in the swift return of client assets and money.

[1] European Commission (DG Internal Market and Services) working document: Technical details of a possible EU framework for bank recovery and resolution (6 January 2011), http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.
[2] European Commission communication: An EU framework for crisis management in the financial sector (20 October 2010), http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf.
[3] Report and Recommendations of the Cross-border Bank Resolution Group (March 2010), http://www.bis.org/publ/bcbs169.pdf.

The EU Consultation Paper envisages granting supervisory authorities certain emergency powers and tools to intervene at an early stage and to restructure or resolve financial institutions without resorting to the use of taxpayers' funds involved in a public sector bail-out. We summarise below the key proposals under consideration.

Scope

The Commission proposes that all credit institutions (as defined in Article 4(1) of the Banking Consolidation Directive (2006/48/EC) ("BCD")) should come within the scope of the regime. It also intends that certain investment firms should be subject to the provisions, including those that are part of a banking group or those that execute orders on behalf of clients and meet certain size tests (not yet specified). The Commission is also seeking views as to whether EU holding companies of credit institutions and other financial companies should be included.

Resolution Authorities

Each member state will be required to identify a "resolution authority" to exercise the resolution powers, which authority should be functionally separated from the supervisors (although it envisages the supervision and regulatory functions could be within the same organisation). It also envisages that the European Banking Authority ("EBA") would be given a significant role in the supervision of the proposed framework and the development and coordination of recovery and resolution plans.

Supervision, Planning and Prevention

The Commission intends to reinforce the supervisory regime under the Capital Requirements Directive ("CRD"), by providing for enhanced supervision of credit institutions, and requiring recovery and resolution plans as a key component of an effective crisis management regime.

Recovery planning

All credit institutions and investment firms covered by the proposed framework would be required to prepare and maintain, and submit to supervisors for assessment, detailed recovery plans setting out measures they would take in different stress scenarios, assuming no public sector support. In addition, the Commission proposes that EU parent banks or financial holding companies should prepare group recovery plans (including a recovery plan for each constituent entity). These measures are aimed at restoring the long term viability of the entity where it has suffered a material deterioration in its financial situation.

The Commission proposes that the recovery plans should reflect the size of the institution, its funding sources and the availability of any financial support and include, among other things: (i) measures to restore its capital, to ensure adequate access to liquidity and to reduce risk and leverage, (ii) arrangements for the sale of assets or businesses and for intra-group financial support and (iii) other management strategies to restore financial soundness.

Intra-group financial support

The Commission is considering establishing a framework for intra-group liquidity management to facilitate asset transfers within a group where a group entity is experiencing liquidity stress. This would involve supervisors giving prior approval to shareholders' agreements setting out the conditions for asset transfers. It also considers options under which, subject to prior authorisation of the consolidating supervisor, financial support could be provided between group companies where an entity is experiencing financial difficulties.

Resolution plans

In addition to recovery planning specified above, to deal with the situation where an entity has failed and there is no realistic prospect of recovery, the Commission believes that resolution authorities should, in consultation with supervisors, draw up and maintain both an individual resolution plan for each institution, and a group resolution plan for each banking or financial group, which is under its remit. This will generally be with a view to transferring or winding down the relevant business.

The Commission sets out issues it believes a resolution plan could cover, including the options under different stress scenarios, financing, critical functions and measures to ensure continuity of arrangements and necessary information for resolution authorities to apply the resolution tools and powers. Upon request by the resolution authorities, an institution should provide them with relevant information including its (or group members') legal and operational structures, a list of critical economic functions within the group mapped to business lines and details of intra-group and counterparty exposures.

Group level resolution authorities should be responsible for drawing up and maintaining group resolution plans and cooperating with other relevant resolution authorities. It is proposed such plans should contain various information, including the circumstances in which a group resolution would be appropriate, the extent to which resolution tools and powers could be applied at the group level and how group resolution options would be financed.

Early Intervention

With the stated aim of seeking to address developing problems at an early stage, the Commission proposes to extend the powers of intervention under Article 136(1) of the CRD so that supervisors may intervene in circumstances of likely breach of the CRD. It also proposes to increase the powers available to regulators, including requiring the institution to take steps to raise additional capital, restricting or limiting its business, imposing additional reporting requirements or requiring it to draw up and implement a specific recovery plan.

The Commission is also considering giving relevant supervisors the power to appoint a special manager for a period of up to one year to replace or assist the management of a failing institution. It proposes that such powers should be exercisable either (i) where the institution fails to provide or implement a specific recovery plan requested by the supervisor or where the supervisor considers that the proposed recovery plan would not lead to a recovery of the relevant entity or (ii) the supervisor believes management is unwilling or unable to take measures required by the supervisor in exercising its powers of intervention under the CRD.

In relation to groups where there is more than one relevant supervisor, the Commission suggests that the consolidating supervisor, in cooperation with other supervisors involved within the relevant supervisory college, should assess whether coordination is desirable on the grounds that it would be more likely to restore the viability of the relevant entities and preserve the financial soundness of the group as a whole (taking into account any likely adverse impact on other entities within the group).

Resolution Tools and Powers

Trigger conditions, resolution objectives and general principles

The Commission believes that resolution authorities should apply the resolution tools and powers when a credit institution is failing or likely to fail and there is no reasonable prospect that it will be able to rectify the situation within a reasonable period. The action should also be justifiable in the public interest.

The Commission is considering three alternative trigger options:

Option 1 (solvency test): i) the entity has incurred, or is likely to incur, losses that will deplete equity; (ii) its assets are, or are likely to be, less than its liabilities; or (iii) it is, or is likely to be, unable to pay its debts in the normal course of business.

Option 2 (regulatory authorisation test): it no longer fulfils the financial conditions for authorisation (or is likely to fail to do so).

Option 3 (regulatory capital test): it no longer possesses, or is likely to cease to possess, sufficient tier 1 instruments to meet the requirements of the CRD.

The Commission believes that in exercising their resolution powers, the relevant authorities should have regard to the following "resolution objectives": (i) ensuring the continuity of essential financial services, (ii) avoiding adverse effects on financial stability, (iii) protecting public funds, and (iv) protecting insured depositors. It also believes the authorities should be guided by certain general principles, including that shareholders should first bear the losses of the institution and unsecured creditors bear the residual losses. Creditors of the same class should be treated in a fair and equitable manner and no creditor should incur greater losses than it would under a liquidation.

Resolution tools

The Commission proposes that resolution authorities be given the following resolution tools:

Sale of business tool: the sale of the bank or the whole or part of its business on commercial terms without shareholders' consent or other procedural requirements.

Bridge bank tool: the transfer of all or part of the bank's business to a "bridge bank," which is wholly owned by a public authority (intended to be a temporary measure pending sale to the private sector).

Asset separation tool: the transfer of certain high-risk assets of the bank to an asset management vehicle owned by a public authority. Due to moral hazard concerns, the Commission intends this tool to be used in conjunction with another resolution tool.

Debt write-down or conversion tool: the write-down of the claims of unsecured creditors of a failing bank or the conversion of debt claims into equity (but preserving the insolvency ranking of claims and *pari passu* treatment of creditors within the same class).

The Commission notes that the write-down proposal gives rise to legal and practical challenges and relates to other work in the international community, including the ongoing work by BCBS on loss absorbency of capital instruments at the point of non-viability. It therefore provides only a general overview of how such provisions might operate in practice and the relevant issues. It sets out two potential models. The first is to give authorities the power to write down or convert into equity, all senior debt (or, at their discretion, certain classes of senior debt) issued after the proposals come into effect (subject to certain exemptions, including swap and repo transactions, short-term debt, deposits and secured debt). The second option is to require banks to issue a fixed volume of "bail-in" debt, which could be written down or converted into equity upon a statutory trigger. Such instruments must specify that the relevant resolution authority may exercise a statutory power to write down the debt if the trigger conditions apply. The amount of the write-down or the conversion rate may either be specified in the bail-in instrument or left to the discretion of the resolution authorities.

The suggestion that authorities could be given the power to write down any senior debt of financial institutions has given rise to particular concern amongst market participants and would be likely to have a significant impact on the pricing and liquidity of senior bank debt in the future. Providing authorities with such powers would appear to go far beyond the recommendations to date of the BCBS which has been focused on ensuring that capital instruments issued by banks that qualify as tier 1 or tier 2 capital have the ability to absorb losses at the point of non-viability of the entity.

Resolution powers

The Commission proposes that resolution authorities should have various powers to enable them to apply the resolution tools effectively, including the power to take control of the relevant entity, to remove or replace its senior management and transfer its shares and debt instruments (or issue new shares). The authorities should also have the power to reduce or write off the claims of unsecured creditors.

Procedural obligations and protection of stakeholders

The Consultation Paper sets out proposals to ensure that resolution measures are properly notified and made public. It also states that the resolution framework should provide for safeguards and compensation for interference with the property rights of shareholders, creditors and other third parties, to ensure that they suffer no greater loss than they would in an insolvency.

Partial Property Transfers

The Commission proposes to include safeguards for the rights of counterparties where a resolution authority uses its powers to effect a partial property transfer of the assets of the affected credit institution or to modify the terms of a contract to which it is a party. It believes the safeguards should apply irrespective of how these arrangements, have been created (e.g., contract, trust or operation of law). It believes safeguards are needed in respect of (i) security arrangements (whether by fixed or floating charge), (ii) title transfer financial collateral arrangements, (iii) set off arrangements, and (iv) netting arrangements.

In relation to financial collateral, set-off and netting arrangements, the Commission believes that, subject to certain limited exceptions, there should not be a transfer of some but not all of the rights and liabilities protected by such an arrangement, nor a modification or termination of such rights and liabilities. Where liabilities are secured under a security arrangement, the protections should ensure that any secured liability is transferred with the benefit of the security (and vice versa) and there should be no transfer of assets against which the liability is secured unless the liability and benefit of the security are also transferred.

The Commission proposes equivalent safeguards to prevent a partial transfer, termination or modification of the property, rights and liabilities forming part of a structured finance arrangement, including securitisations and covered bonds.

Other Matters

In relation to cross-border financial groups, in the absence of a harmonised insolvency regime and a single EU supervisory authority for those groups, the Commission proposes a coordination framework based on common resolution tools and an obligation for authorities to consult and cooperate when resolving cross-border groups. This will include the establishment of resolution colleges of supervisors for crisis planning, developing common approaches to the application of resolution tools and coordinating resolution measures and actions by resolution authorities.

The Commission also proposes that member states be required to establish a bank resolution fund to cover the costs incurred in using the resolution tools. Such fund will have a target size, defined as a percentage of the aggregate eligible liabilities of all contributing institutions. It is envisaged that every credit institution and investment firm authorised in a member state should contribute pro rata to the resolution fund.

Next Steps

The deadline for responding to the consultation is 3 March 2011. The Commission stated that it intends to adopt a legislative proposal in June 2011 based on the consultation responses and an impact assessment.

Although the proposal for a resolution and recovery framework for banks in the EU is not surprising and is consistent with the objectives of the G-20, some of the proposals are controversial, in particular the suggestion that regulators be given the power to effect a mandatory write-down of all senior bank debt issued after the proposals come into effect (with certain exceptions). It is also interesting to note that the EU proposals do not contain specific proposals aimed at the speedy recovery of client assets in the event of an insolvency of an investment bank, as the new UK special administration regime for investment banks does.

As mentioned above, the BCBS is conducting ongoing work in relation to systemic issues relevant to global financial institutions including how they can absorb losses on a going concern basis. It is to be expected that the outcome of this work will impact the EU Commission proposals as set out in the Consultation Paper. Certain aspects of the Consultation Paper including some of the possible approaches for requiring write-downs of debt and equity go further than existing BCBS recommendations and are likely to be the subject of considerable debate during the consultation process.

The Commission also plans to examine the need for further harmonisation of bank insolvency regimes and will publish a report (and possibly a legislative proposal) by the end of 2012. It is considering the creation of an integrated resolution regime by 2014.

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