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Structured Thoughts

News for the financial services community.

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Family Offices

On June 22, 2011, the SEC voted unanimously to adopt Rule 202(a)(11)(G)-1 under the Advisers Act, which provides an exemption from most provisions of the Advisers Act to certain family offices. To qualify for the exemption, a family office must:

- provide advice about securities only to certain "family clients";
- be wholly owned by family clients and exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and
- not hold itself out to the public as an investment adviser.

Rule 202(a)(11)(G)-1(d)(4) provides that "family clients" include current and former family members; certain employees of the family office (and, under certain circumstances, former employees); charities funded exclusively by family clients; estates of current and former family members or key employees; trusts existing for the sole current

benefit of family clients or, if both family clients and charitable and non-profit organizations are the sole current beneficiaries, trusts funded solely by family clients; revocable trusts funded solely by family clients; certain key employee trusts; and companies wholly owned exclusively by, and operated for the sole benefit of, family clients (with certain exceptions).

The Dodd-Frank Act prohibits the SEC from excluding from its definition of family office persons not registered or required to be registered on January 1, 2010 that would meet all of the required conditions under Rule 202(a)(11)(G)-1 but for their provision of investment advice to certain clients specified in Section 409(b)(3) of the Dodd-Frank Act.[1] In addition, Rule 202(a)(11)(G)-1(e)(2) provides that family offices currently exempt from registration under the Advisers Act in reliance on the private adviser exemption and that do not meet the new family office exclusion are not required to register with the SEC as investment advisers until March 30, 2012.

This final rule reflects a number of changes based on input received during the comment process. Please see our client alert on the rule proposal at http://www.mofo.com/files/Uploads/Images/101018-Family-Offices.pdf. Institutions that interact with family offices may wish to alert them regarding these changes (many of the changes will prompt some restructuring on the part of many family offices). To the extent that investor representation letters or other documents in use currently include references to "family offices" generically, institutions may want to review and revise the documentation in order to include specific reference to the formalized definition of the term now contained in the rules.

For information on the other changes adopted by the SEC that affect investment advisers, please see our alert at http://www.mofo.com/files/Uploads/Images/110624-Advisers-Act-Provisions-of-Dodd-Frank.pdf.

The Freezer: Holding Structured Products in Inventory

Clients frequently ask us whether they, as underwriters, can take structured notes that are being offered by them and hold them in inventory, or in the "freezer," and resell the securities at a later time. This question raises a number of interesting issues.

From a disclosure perspective, investors would want to know the portion of the offered securities that will be purchased or held by the underwriter in the offering. Often, this information provides some indication as to whether the offering was successful. An indication of the principal amount of the notes that was purchased by investors may in some cases provide some degree of information as to the potential liquidity of the secondary market for the issuance. The issuer and the underwriter will want to be certain that the prospectus discloses that certain securities will be purchased by the underwriter and held for future resale, and some indication of the price or prices at which such securities will be resold (i.e., will the securities be resold at a fixed price, or at variable prices in the future). Also, the prospectus should disclose whether the underwriters will use the same offering document to re-offer the securities that were purchased by them for future resale.

From the perspective of both the issuer and the underwriter, it will be important, as we discuss further below, that the prospectus discloses that it may be used or delivered by the underwriter when it is making further resales.

From a securities law perspective and a FINRA perspective, it is important to note how much of the offered securities will be purchased by the underwriter for future resales. We noted above the disclosure concern. Apart from that, the securities being purchased by the underwriter may be viewed as an unsold allotment. The underwriter will need to deliver a prospectus in connection with any shares that constitute or that are viewed as an unsold allotment. The underwriter will want to take the securities into an investment account so that the initial offering of the securities can be deemed completed. This is important for several reasons. For Regulation M purposes, the issuer will want to deem the offering completed. The issuer will not want to be deemed to be engaged in a

[1] Dodd-Frank Act, Sections 409(b)(3) and (c).

continuous offering. If the offering were deemed a continuous offering, then would it be deemed a variable price deal?

The issuer and the underwriter also will want the lead underwriter to give an "all sold notice" for the transaction so that a secondary trading market can develop for the securities. For TRACE purposes, the issuer and the underwriter and other dealers or distributors will want to know how to mark the securities for FINRA TRACE reporting purposes, and whether it is a primary or a secondary offering (for the indicator, P1 or S1).

Similarly, from a FINRA perspective, FINRA will be interested in whether there was a good "distribution" of the securities in the initial offering. If too large (over 15% is a frequently cited number—although there is no "bright line" test) a percentage of the offered securities is purchased by the issuer or an affiliate of the issuer or the underwriter, then the offering may not be deemed a broad distribution for FINRA purposes.

Holding securities in inventory also potentially involves a variety of U.S. federal tax issues. We describe these issues in detail in our March 2010 issue of "TaxTalk": http://www.mofo.com/files/Uploads/Images/100402TaxTalk.pdf.

Product Intervention: An Update

As we have previously discussed,[2] the UK Financial Services Authority (the "FSA") signaled a sea change in the way retail financial products will be regulated in the UK in its Discussion Paper[3] 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[4] 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[5] setting out the proposed framework for the new regulatory regime. At around the same time, the FSA also published a discussion paper[6] setting out its proposals for the approach to regulation by the FCA which therefore ties in with the more interventionist approach to product regulation referred to above.

The FSA states in the Feedback Statement that consumer organizations 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

[2] See client alert, FSA Product Intervention dated March 14, 201: http://www.mofo.com/files/Uploads/Images/110314-FSA-Product-Intervention.pdf.
[3] FSA discussion paper (DP11/1): Product Intervention (January 25, 2011), http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf (comments Deadline: April 21, 2011).
[4] http://www.fsa.gov.uk/pubs/discussion/fs11_03.pdf.
[5] http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf.
[6] 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 in 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 behavior. 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.

Read our detailed alert on Product Intervention at http://www.mofo.com/files/Uploads/Images/110705-Product-Intervention-in-the-UK-and-the-New-FCA.pdf.

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

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

About Morrison & Foerster

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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.