Morrison & Foerster News Bulletin Volume 2, Issue 12 August 25, 2011

Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Credit Ratings and Credit Risk: Frequently Asked Questions

Introduction

Over the past two years, there has been a considerable amount of regulatory activity related to credit ratings and rating agencies. Each of these developments has impacted in some way the structured products industry. However, the frequency of these developments has made it difficult for many people to track them. Accordingly, we set forth below the answers to a number of common questions that industry participants are asking about these developments.

When can an issuer's specific credit ratings be disclosed in structured note offering documents?

Prior to July 2010, it was a fairly common practice (but by no means a uniform practice) for prospectuses and free writing prospectuses ("FWPs") to disclose the applicable issuer's credit rating.

However, effective July 2010, the Dodd-Frank Act repealed SEC Rule 436(g). In a nutshell, the impact of this repeal was to require the consent of the relevant rating agency to state its credit rating in the prospectus for a registered public offering. Since rating agencies generally were not willing to do so, mainly due to liability concerns, issuers were removed the credit ratings from prospectuses. As a result, it remains the market practice not to include the issuer's specific ratings in the prospectus for the offering.

That being said, the following types of documents were not directly impacted by the repeal of Rule 436(g), and may continue to state the issuer's credit rating:

- Free writing prospectuses.
- Offering documents for non-registered offerings, such as Rule 144A offerings, bank note(3(a)(2)) offerings, and offerings of structured certificates of deposit.

Of course, if such an offering document does include ratings information, it would be appropriate to consider the use of appropriate cautionary information about the limitation of credit ratings and related disclosures.

Must an issuer's ratings downgrade be disclosed to investors?

Issuers and underwriters of structured products should be appropriately careful to disclose to investors material information about an issuer's credit quality, particularly if there is any deterioration of the issuer's financial condition. For example, FINRA's April 2011 consent agreement with UBS,[1] relating to the sale of Lehman Brothers notes, critiques the broker-dealer for not having procedures in place to ensure that its investors were aware of Lehman Brothers' deteriorating financial situation.

Different circumstances may dictate the types of information that should be communicated to investors. In some cases, it is the downgrade of a credit rating that may be relevant. In other cases, it will be other factors, such as a weakening balance sheet, or significant increases in the issuer's credit spreads. Issuers and underwriters should carefully consider the relevant information in the context of any particular issuer and offering.[2]

Can structured note offering documents disclose the risk that declines in the issuer's credit rating may impact the value of the structured notes?

Yes. Following the repeal of Rule 436(g), the SEC indicated that no consent from a rating agency would be required when an issuer includes disclosures in its prospectuses as to credit ratings, when used in the context of a discussion about the impact to the issuer of changes to its credit ratings.[3] To the extent that a downgrade of an issuer's rating could reduce the value of a structured product, it may be potentially material disclosure.[4]

The SEC is removing references to credit ratings from a variety of its rules. Must our offering documents also remove them?

No. The Dodd-Frank Act requires the SEC to consider how its reliance on credit ratings can be reduced, and to take steps to remove references to those ratings from its own rules.[5] However, except with respect to the consent issue discussed above as to the disclosure of actual ratings, neither the Dodd-Frank Act nor any regulation adopted thereunder instructs or requires issuers to remove references to their credit ratings. To the extent that this

[1] The agreement may be found at:
http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123478.pdf.

[2] The disclosure may take a variety of forms. For example, many financial institution issuers disclose this information in their periodic reports that are incorporated by reference in the relevant prospectus (typically in an "MD&A section"). These disclosures can be updated through new Exchange Act filings. In addition, representatives of broker-dealers often have oral discussions with investors as to the credit quality of the relevant issuers, and may discuss developments relating to credit quality.

[3] See SEC Compliance and Disclosure Interpretation No. 233.04 (July 27, 2010).

[4] We note that in the typical structured note risk factor, the possibility of a downgrade and its potential impact is discussed, but not the actual credit rating provided by the rating agency.

[5] Section 939A of the Dodd-Frank Act. See also our client alert, "Dodd-Frank Update: SEC Adopts New Criteria to Replace Credit Ratings to Determine Short-Form Eligibility," http://www.mofo.com/files/Uploads/Images/110801-Dodd-Frank-Update.pdf.

information is significant to an investor, such as in the case of the potential adverse impact of a ratings downgrade discussed above, it remains appropriate to disclose this possibility.

Where and how should "issuer credit risk" be disclosed?

In the aftermath of the Lehman Brothers' bankruptcy, most parties in the structured products market have sought to enhance the disclosures relating to issuer credit risk, and to better clarify any disclosures relating to "principal protection." The SEC and FINRA have both commented on the need for disclosure of "principal protection" to be appropriate and balanced.[6] The U.S. District Court for the Southern District of New York, in a recent decision relating to the UBS litigation,[7] emphasized the importance of ensuring that any disclosure of principal protection is properly balanced with disclosure of issuer credit risk. Accordingly, issuers and underwriters should be vigilant to ensure that their offering documents, to the extent that they reference the possibility of repayment of principal, provide appropriate and properly placed disclosures as to the issuer's credit risk.

* * *

The regulation of credit rating agencies, and disclosure of credit ratings, remains an active area. The repeal of Rule 436(g) may have limited the ability of some issuers and underwriters to disclose actual credit ratings in certain offering documents. However, rating downgrades, the potential impact of rating downgrades, and issuer credit risk all remain areas for consideration of proper disclosure in the structured products industry.

New Hampshire Securities Regulator Announces Structured Products Settlement

On August 23, 2011, the New Hampshire Bureau of Securities Regulation announced that it had issued a consent order in its proceedings against UBS Financial Services, Inc. relating to sales of Lehman Brothers structured products. The payment agreed to under the consent order will cover restitution to investors, as well as fines and costs. The consent order is available on the Bureau's site. Like the FINRA consent relating to the Lehman Brothers products, this consent order also references credit default swap trends as an indicator of the enhanced credit risk of Lehman Brothers during the relevant periods. Also consistent with the FINRA consent, this order identifies concerns relating to training and supervision of financial advisers.

For questions, please contact:

Ze'-ev Eiger, zeiger@mofo.com, 212-336-8222

Elise Kim, elisekim@mofo.com, 212-336-4045

Indira Lall, ilall@mofo.com, 202-778-1446

David Lynn, dlynn@mofo.com, 202-887-1563

[6] See Structured Notes with Principal Protection: Note the Terms of Your Investment (http://www.sec.gov/investor/alerts/structurednotes.htm) and FINRA Regulatory Notice 09-73 Principal Protected Notes.

[7] See "In re: Lehman Brothers Securities and ERISA Litigation," 2011 U.S. Dist. LEXIS 82119 (July 2011).

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.

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life science companies. We've been included on *The American Lawyer*'s A-List for eight straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

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.