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Structured Thoughts

News for the financial services community.

FINRA Amendments Expanding TRACE to Include Agency Debt Securities and Primary Market Transactions Become Effective March 1, 2010

In September 2009, FINRA issued its regulatory notice no. 09-57, regarding the approval by the SEC of major amendments to the TRACE Rules (FINRA Rule 6700 Series) and FINRA Rule 7730 (relating to TRACE fees), that will increase the number and type of securities and transactions that will be reported to TRACE. These amendments become effective March 1, 2010.

The notice may be accessed via FINRA's website:
http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120043.pdf.

The amendments delete the criteria that a security be investment grade or non-investment grade and depository eligible under NASD Rule 11310(d). The amendments also expand the term "TRACE-Eligible Security" to include a debt security issued or guaranteed by an Agency or a Government-Sponsored Enterprise. For purposes of FINRA Rule 6710(k), "Agency" means a U.S. "executive agency" as defined in 5 U.S.C. § 105; however, the term "Agency" excludes the U.S. Department of the Treasury (the "Treasury") in the exercise of its authority to issue Treasury securities. In FINRA Rule 6710(n), "Government-Sponsored Enterprise" has the same meaning as defined in 2 U.S.C. § 622(8). Fannie Mae and Freddie Mac are examples of Government-Sponsored Entities.

TRACE-Eligible Securities do not include debt securities that at issuance have maturities of one year or less. Also excluded are asset-backed securities (as that term is used in Securities Act Regulation AB, Section 1101(c)), mortgage-backed securities, collateralized mortgage obligations, synthetic asset-backed securities, or any instrument involving or based on the securitization of mortgages or other credits or assets, including but not limited to collateralized debt obligations, collateralized bond obligations, collateralized debt obligations of asset-backed securities, or collateralized debt obligations of collateralized debt obligations.

The amendments also expand TRACE to include primary market transactions as Reportable TRACE Transactions, as defined in FINRA Rule 6710(c), and require members to report transactions in Agency Debt Securities and primary market transactions under FINRA Rule 6730. FINRA identifies two types of primary market transactions, List or Fixed Offering Price Transactions and Takedown Transactions, that will be subject to more liberal trade reporting requirements. A "Listed or Fixed Offering Price Transaction" is defined in FINRA Rule 6710(q) as a primary market sale sold on the first day of trading of a new issue: (i) by a sole underwriter, syndicate manager, syndicate member, or selling group member at the published or stated list or fixed offering price, or (ii) in the case of a primary market transaction effected under Securities Act Rule 144A, by an initial purchaser, syndicate manger, syndicate member, or selling group member at the published or stated fixed offering price. In FINRA Rule 6710(r), a "Takedown Transaction" means a primary market sale transaction sold on the first day of trading of a new issue: (i) by a sole underwriter or syndicate manager to a syndicate or selling group member at a discount form the published or stated list or fixed price offering, or (ii) in the case of a primary market sale transaction effected under Securities Act Rule 144A, by an initial purchaser or syndicate manager to a syndicate or selling group member at a discount from the published or stated fixed offering price. Listed or Fixed Offering Price Transactions and Takedown Transactions also will not be disseminated as provided in FINRA Rule 6750(b)(3).

The SEC also approved new FINRA Rule 6770, granting FINRA emergency authority to suspend the reporting and/or dissemination of certain transactions in TRACE-Eligible Securities or certain reporting or dissemination requirements as market conditions warrant and in consultation with the SEC.

On March 1, 2010, the amended TRACE Rules and amended FINRA Rule 7730 will be effective and members must begin reporting transactions in Agency Debt Securities and primary market transactions and comply with all other requirements in these amended rules.

S&P Withdraws Ratings from Equity- and Commodity-Linked Structured Notes

In December 2009, Standard & Poor's ("S&P") announced that, beginning March 31, 2010, it will begin withdrawing ratings from structured notes with variable principal payments linked to equity prices, commodity prices, or equity or commodity indices. This decision affects only certain structured notes; S&P will continue to rate equity- or commodity- linked notes provided that the return of principal is guaranteed, as well as products that provide solely for a conditional interest payment. Additionally, S&P will continue to rate credit-linked notes and provide issuer credit ratings.[1]

S&P's adjustment is an attempt to avoid confusion among the different risks that underlie structured notes: market risk and credit risk. Credit risk applies to all obligations, and reflects the likelihood that the issuer will have the funds available at maturity to pay the principal amount. Market risk applies only to notes in which payment depends on an external measure, and reflects the likelihood that the note's terms will result in a return of principal. By way of example, an issuer might sell a structured product where the terms provide for repayment of principal only if the gold spot price has increased on a date twelve months after settlement. Credit risk is the likelihood that the issuer will have sufficient financial resources available to pay its obligations whether or not gold appreciates; market risk is the likelihood that gold will, in fact, appreciate twelve months down the line.

An investor could suffer serious consequences if she confuses market risk and credit risk; different notes can pose identical credit risks yet present very different overall risk profiles. The concern is that S&P's ratings—which apply only to credit risk—might add to this confusion by being misread as applying to market risk. Driven by these concerns, S&P released a request for comments in May 2008, asking market participants to remark on an updated framework for structured note ratings.[2] S&P's announcement last month is simply another step in this ongoing process to minimize confusion, this time by withdrawing its ratings on notes where the repayment of principal depends, directly or indirectly, on equity or commodity prices. In doing so, S&P seeks to highlight the primarily non-credit risks associated with those structures.

[1] Moody's Inc. announced similar changes to its treatment of structured notes in June 2009. *See* "Moody's Update on Rating Debt Obligations with Variable Promises," June 2009.
[2] http://www.standardandpoors.com/prot/ratings/articles/en/us/?assetID=1245199732032.

Structured note issuers may need to update their disclosures in light of S&P's decision not to rate certain structured notes, at least to the extent they reference their ratings (that is, their issuer credit ratings) in the offering documents. Specifically, structured note issuers should ensure that, when including issuer credit ratings in a prospectus, they indicate that the ratings apply only to the issuer, and not to the structured notes. These changes by the S&P are only the most recent in a string of updated disclosure issues for structured notes issuers,[3] issues that structured note issuers and underwriters should continue to monitor.

Is Bigger Better? To Tap, or not to Tap? (Re-openings)

Frequent issuers of debt securities often want the option of "re-opening" a series of debt securities. After the original issuance date of a series of debt securities, the issuer and underwriter may choose to offer additional notes having exactly the same terms and conditions, including the same CUSIP number. Through a re-opening, the issuer can raise additional proceeds. Presumably, a larger class of debt securities will be more liquid. There are a number of important differences between both market practice and applicable regulations relating to "tapping" or "re-opening" a series of debt securities in the U.S. and Europe, which we discuss below. We also discuss below the U.S. tax implications of re-openings.

Is a re-opening possible? First, the issuer should ensure that the applicable indenture or fiscal and paying agency agreement permits the issuance of additional notes without noteholder consent or other preconditions. Most continuous offering programs, like MTNs or bank note programs, do permit re-openings. The offering documents for the program or the specific takedown (pricing supplement or prospectus supplement) should disclose the issuer's ability to issue additional notes of the same class.

In the U.S., registered note offerings do not typically include an over-allotment option or option permitting the underwriter to purchase additional notes within a specified period of time. Additional investor interest may be satisfied through a re-opening. The pricing supplement or prospectus supplement for the re-opening should clearly set out the amount of offered notes that have been priced and sold. For a public offering, an issuer must indicate whether a significant portion of the offered securities have been sold to an affiliate of the issuer or to the underwriter or its affiliates. If a significant percentage of the offered securities have been placed with an affiliate or the underwriter, it may signal an unsuccessful offering, that there has not been a broad public distribution, or that there will be limited secondary market liquidity.

Offered securities purchased by the underwriter or its affiliates and subsequently re-offered or re-sold should not be confused with a re-opening. The securities purchased by the underwriter or its affiliates would have to be purchased and held in a proprietary account for some period of time prior to their re-offer and may upon their re-offer, after the passage of time, be considered secondary securities. In addition, properly seasoned debt securities are treated differently for U.S. tax purposes from securities that are re-opened. Such securities generally would not be subject to tax restrictions on re-openings because they would be treated as having been issued at original issuance and the re-offer would be considered to be made in the secondary market.

If orders for the offered securities have not been received, and the issuer intends to continue to offer the securities over some period of time, the offering will not be deemed completed and the offering would be considered a continuous, or ongoing, offering. If the offering is not completed, this has Regulation M, trade reporting, and other consequences.

Aside from these disclosure and compliance issues, a reopening may raise a number of tax issues for the holders of the securities. Re-opening a debt issue can have a significant tax impact, particularly where, due to market movements, the additional notes are issued at a discount. To be fungible from a tax standpoint, a re-opening of securities treated as debt for U.S. tax purposes must satisfy one of three tests: the original notes and the additional

[3] For discussion of a related development, see an earlier client alert discussing the SEC's proposed rules on ratings disclosure for issuers. http://www.mofo.com/news/updates/files/091012SEC_Proposes.pdf.

notes must be part of the same "issue" (under the 13-day rule, discussed below), or the additional notes must be part of a "qualified re-opening" of the original notes (under one of two alternative tests, also discussed below). In the case of "structured notes," the tax consequences of a re-opening will depend on the tax characterization of the structured notes themselves: are the notes "debt" for tax purposes and, if so, are the notes "contingent payment debt instruments?" If the notes are contingent payment debt instruments, issuers will typically re-open only if the 13-day rule discussed below is satisfied because the qualified reopening rules are not available for contingent payment debt securities. For structured notes not treated as debt, the tax implications of a reopening will depend on the specific terms of the notes: if the notes are treated for tax purposes as a single instrument, re-openings may be liberally available and, if not, there may be significant restrictions on re-openings intended to be fungible with the original issuance.

13-Day Rule

Under applicable regulations, an "issue" of debt instruments includes all debt instruments with the same credit and payment terms that: (1) are issued either pursuant to a common plan or as part of a single transaction or a series of related transactions, and (2) are issued within a period of 13 days beginning with the date on which the first debt instrument that would be part of the issue is sold to a person other than a bond house, broker, or similar person or organization acting in the capacity of an underwriter, placement agent, or wholesaler.

Qualified Re-opening

The regulations provide rules for two types of qualified re-openings. Under the first rule, a re-opening of debt instruments is treated as a qualified re-opening if:

- the original notes are "publicly traded,"
- the issue date of the new notes (treated as a separate issue) is not more than six months after the issue date of the original notes, and
- on the pricing date of the re-opening (or, if earlier, the announcement date), the yield of the original notes (based on their fair market value) is not more than 110% percent of the yield of the original notes on their issue date (or, as is often the case, if the original securities were issued with no more than a de minimis amount of original issue discount ("OID") their coupon rate).

Alternatively, a re-opening of debt instruments (regardless of whether the re-opening occurs within six months or not) is treated as a qualified re-opening if:

- the original notes are "publicly traded," and
- the additional notes (treated as a separate issue) are issued with no more than a de minimis amount of OID.

Publicly Traded Test

Applicable regulations provide detailed rules that define when notes are treated as "publicly traded." The intention of this test is to define a set of circumstances where one may reasonably conclude that the fair market value of the notes is accurately reflected in their trading price.

See more on qualified re-openings of debt securities in MoFo Tax Talk Volume 2, Issue 1: http://www.mofo.com/files/Publication/2c744b4e-7c3a-4e86-9a3e-b804836bd492/Presentation/PublicationAttachment/dd1fa47f-9688-4cff-aa5b-fec23f137e20/090310TaxTalk.pdf.

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