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Structured Thoughts

News for the financial services community.

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Repackagings

We are often asked to consider whether "bundling" certificates of deposit (CDs) and offering interests in these CDs would be considered a new instrument and whether the FDIC insurance would still be passed along to investors purchasing the interests. Generally, brokered CDs purchased by a financial intermediary and held by a trustee, on behalf of investors, will be bank deposits and not securities.[1] However, does the sale of interests in a CD or the bundling of CDs create a different result?

The starting point for this analysis is the Staff's position in a no-action letter to *E.F. Hutton & Co., Inc.* (pub. avail. Mar. 28, 1985). In the *E.F. Hutton* letter, the Staff indicated that no enforcement action would be recommended if E.F. Hutton offered and sold units in an irrevocable trust holding a single, non-negotiable, jumbo CD without registration under the Securities Act and without registration of the trust as an investment company. In granting this relief, the Staff noted that (1) each owner of a unit of the trust would be recognized by the financial institution as a beneficial owner of the CD, and would have the right to proceed directly against the financial institution and the trustee; (2) the CD would be selected prior to the sale of units and identified in the offering material for the units; (3) the trustee would perform only ministerial functions related to collections from the financial institution and disbursements to the owners of the trust units; and (4) the interest of each trust unit owner in the CD would be federally insured through both the trustee and the financial institution.

[1] In *Marine Bank v. Weaver*, 455 U.S. 551 (1982), the Supreme Court held that a CD purchased from an issuing bank is generally not a security under the antifraud provisions of the federal securities laws, noting that each transaction must be analyzed based on the "content of the instruments in question, the purposes intended to be served, and the factual setting as a whole."

The Staff's position in *E.F. Hutton* did not reference the fact that one CD involved in the transaction was a distinguishing factor in determining if the units represented a separate security. In this regard, the incoming letter in *E.F. Hutton* noted:

> In our opinion, other forms of similar transactions, such as those in which separate certificates of deposit are issued and delivered directly to purchasers through an underwriter or where a trustee holds large numbers of individual and separate certificates of deposit with the purchasers holding divided (specifically identified) interests in individual certificates, would clearly be exempt from registration or compliance under either the 1933 Act or the 1940 Act. We believe that, under the circumstances discussed throughout this letter, a mere change of structural form for the convenience and benefit of both the Owners and the S&L, particularly where pervasive and substantially identical "banking" laws and regulations continue to exist and where the Owners would be entitled to direct insurance coverage by the FSLIC, should not subject this proposal to the requirements of either the 1933 Act or the 1940 Act.

In no-action letters prior to *E.F. Hutton*, the Staff had considered circumstances including multiple CD structures. For example, in the no-action letter to *The North Carolina State Employees Association, Inc.* (pub. avail. Mar. 13, 1980), while the Staff was unable to provide the requested no-action relief sought under the Investment Company Act with respect to a pooling of members' funds for the purchase of large denomination certificates of deposit due to a lack of sufficient facts, the Staff's response letter noted that "if certificates of deposit were issued by the bank in the names of the Association and the participating members with their respective interests stated, the participations in the certificates may not be separate securities from the certificates themselves." The Staff went on to note that it would be interested in knowing "whether participants would know what securities they would be participating in before they made their investments or whether the selection of such securities would be made subsequently" and "complete details concerning the manner in which purchase payments and payments on maturity are transmitted so that we could discern whether the arrangement presents a risk of loss separate from and in addition to that presented by the underlying investment itself.[2]

Subsequent to the *E.F. Hutton* no-action letter, in *Pension Administrators, Inc.* (pub. avail. Oct. 18, 1989), the Staff considered a situation where a trust was formed for the purpose of aggregating the funds of pension plan clients in a trust for deposit in two separate deposit accounts.[3] In reaching the position that it would not recommend enforcement action if the beneficial interests in the trust were offered and sold without registration under the Securities Act, the Staff noted that: (1) the interest of each employee-participant in the plan would be covered by separate FDIC insurance coverage, subject to the recordkeeping requirements of the FDIC rules; (2) the terms of the bank accounts and the identity of the bank would be determined prior to making any decision to participate in the program; (3) the duties and powers of the trustee would be narrowly circumscribed and purely ministerial in nature, including no discretion to transfer the bank accounts or with respect to the investment of funds, or as to the designation of which bank account to which funds would be deposited or from which funds would be withdrawn; and

[2] By contrast, in a situation where investors gained access to higher yielding accounts than they could otherwise acquire and participated in a collective investment, the Staff was not in a position to grant the requested no-action relief under the Securities Act and the Investment Company Act. In *NEA-New Hampshire Payroll Investment Plan* (pub. avail. Apr. 29, 1983), it was contemplated that teachers would pool payroll deductions to make collective deposits in higher yielding bank accounts (primarily in the form of certificates of deposit) than they could obtain individually, and that each teacher would receive an interest payment based upon the ratio of his or her individual deposits to the total amount deposited.

[3] It was contemplated that the deposit accounts would consist of money market demand accounts. One deposit account was to be the management account, which would serve as the account through which all monies were deposited into or disbursed from the trust, while the second account was to serve as the pooled account, into which participants would deposit monies to be left with the trust for longer periods of time.

(4) the bank accounts were of a type that would be available generally, so that the participants would not be in a position different from what could be obtained by owning the bank accounts separately.[4]

An additional concern of the Staff in analyzing circumstances similar to the structure contemplated in *E.F. Hutton* has been whether there is the potential for an additional risk of loss over and above owning the CDs directly. In *Rappaport and Segal* (pub. avail. May 24, 1988), the Staff considered a structure whereby a corporation proposed to a purchase a large denomination CD through an escrow account established in the company's name. The corporation was to issue confirmation certificates that indicated each investor's proportionate interest in the underlying CD. It was contemplated that payment of the principal and interest by the issuer of the CDs would go to the escrow account and then be distributed by the corporation. The Staff was unable to provide no-action relief under the Investment Company Act with respect to this structure, noting in particular the risk of loss due to potential nonpayment by the company out of the escrowed funds, which created a separate risk of loss in investing in the CDs.[5]

Beyond those situations where underlying assets included CDs or bank deposits, the Staff has addressed analogous circumstances in which, for example, an insured custody receipt would not be viewed as a separate security from the underlying security that the custody receipt represents. Similar to *E.F. Hutton*, the analysis as to whether the custody receipt is a separate security turns on whether the receipt for the underlying security essentially "mirrors" the underlying security.[6] In providing the requested no-action position with respect to Securities Act registration for the custody receipts contemplated in the *Financial Security Assurance, Inc.* and *Financial Guarantee Insurance Company* no-action letters, the Staff particularly noted, among other things, the ability of each owner of a custody receipt to retain the right to proceed against the issuer of the underlying security, and that the custodian would have no right to assert any of the rights and privileges of owners and would perform purely ministerial functions. In addition, the Staff noted the fact that a custody receipt did not represent an undivided interest in all of the securities held by the custodian, but rather represented a direct interest in a security, and that the custodian would forward any notices to the holders of the receipts and could not take action with respect to the securities without instruction from the holders of the receipts.[7]

As noted in the incoming request letter in *Apfel & Co., Inc.* (pub. avail. July 18, 1991), the Staff has considered a variety of factors in determining whether custodial, trust or similar arrangements for the holding of securities result in the creation of "separate securities" for purposes of the registration requirements of the Securities Act. The factors cited in *Apfel & Co.* include:

a) an investor must be recognized as the direct owner of the underlying security and be able to enforce the obligations arising from such security directly and individually, without the necessity of joining the custodian or trustee or other investors as parties;

b) an independent custodian or trustee must be selected in advance of the offering and its functions must be purely ministerial in nature and not involve any investment contract with the holder;

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[4] The Division of Investment Management noted that it would not recommend enforcement action if the proposed transactions occurred without compliance with the Investment Company Act, noting in particular that: (1) the bank accounts would be of the type available to the plans individually; (2) although the administrator could negotiate more favorable interest rates for the bank accounts than could the plans individually, that ability was of secondary importance to the plans; and (3) the anticipated primary benefit to the plans from the bank accounts is a substantial reduction in bookkeeping expenses, bank service charges, and transaction fees than the plans would otherwise have to incur if the bank accounts were maintained individually.

[5] In light of the Division of Investment Management's position, the Staff of the Division of Corporation Finance did not respond to the request. In *Marine Bank v. Weaver*, the Supreme Court noted that in order for an instrument to be considered a security, the investor must be at a risk of loss.

[6] *See*, *e.g., Financial Security Assurance, Inc.* (pub. avail. Mar. 30, 1988); *Financial Guarantee Insurance Company* (pub. avail. Feb. 15, 1989).

[7] *Financial Guarantee Insurance Company*.

c) an investor must purchase the security to be held by the custodian or trustee;

d) an investor must not be adversely affected by a bankruptcy or insolvency proceeding against the custodian or trustee;

e) the custodial arrangement or trust must not spread risk by holding securities of more than one issuer or by employing other risk-spreading devices; and

f) the custodian or trustee must be required to notify the holders in the event of default, must forward to each holder any notices it receives concerning the underlying security and may take action with respect to such security only upon instructions of the holder.[8]

With respect to the factor that the trust or custodial arrangement must not spread risk by holding securities of more than one issuer or employ other risk-spreading devices, it was noted in the incoming letter of *Morgan Stanley & Co., Inc.* (pub. avail. Apr. 3, 1986) that *Kelling & Co., Inc.* (pub. avail. Oct. 22, 1984) appeared to extend this factor by indicating that the certificates can represent an interest in more than one association's obligation.[9]

Generally, then, if the new structure (whether interests in a CD, or interests in bundled CDs) would not appreciably spread or mitigate risks for the holders of the interests, and would not put the holders in a position that differs from purchasing more than one brokered CD directly, it may be reasonable to conclude that a new or separate security has not been created.

By contrast, in *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985), a different conclusion was reached. The court held that CDs sold through a program under which a brokerage firm marketed the certificates and created a secondary market involved a separate investment contract. The court in *Gary Plastic* noted that the brokerage firm had created an investment contract through a common enterprise created by virtue of investigating issuers, marketing the CDs, and creating a secondary market, such that investors expected profits derived solely from the efforts of the brokerage firm and the banks. In particular, the court noted the brokerage firm's activities had significantly exceeded the efforts of an ordinary broker or sales agent, given that the firm's economic power allowed it to negotiate with issuing banks to gain a favorable interest rate, thus making investors dependent on the firm's managerial and financial expertise. Moreover, the court found that investors in the program relied on the ability of the brokerage firm to maintain a secondary market and to provide an option to sell the CDs back to the firm in the event of a drop in prevailing rates, permitting the investors to obtain liquidity that could not be obtained by holding CDs directly. The court also noted the investors' reliance on the firm's continuing marketing efforts for the program (which facilitated the secondary market) and ongoing monitoring of the issuing banks.[10]

There are a number of other circumstances in which the Staff concluded a separate security was deemed to be created. In *Merrill Lynch, Pierce, Fenner & Smith Inc.* (pub. avail. Oct. 28, 1982), the Staff considered whether interests in a trust holding CDs would be considered separate securities for the purposes of the Securities Act and the Investment Company Act. In determining that a separate security existed, the Staff indicated that the interests

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[8] *Apfel & Co., Inc.*, *citing Merrill Lynch, Pierce, Fenner & Smith, Inc.* (pub. avail. Sept. 26, 1990); *Financial Guaranty Insurance Company*; *Financial Security Assurance Inc*; *Kelling, Northcross & Nobriga, Inc.* (pub. avail. Feb. 25, 1987); *E.F. Hutton & Co. Inc.*; and *Gem Savings Association* (pub. avail. Sept. 28, 1983).

[9] In *Kelling & Co., Inc.*, the Staff indicated that it would not recommend any enforcement action if, in reliance upon counsel's opinion that the exemption provided by Section 3(a)(2) of the 1933 Act was available, the certificates of participation were offered and sold to the public as described without compliance with the registration requirements of the Securities Act.

[10] The court stated: "Here investors are buying something more than an individual certificate of deposit. They are buying an opportunity to participate in the CD Program and its secondary market. And they are paying for the security knowing that they may liquidate at a moment's notice free from concern as to loss of income or capital, while awaiting FDIC or FSLIC insurance proceeds."

represented certificates of interest in a profit-sharing agreement and investment contracts. The Staff noted in making this determination:

> In essence, the trust is a mechanism intended to enable investors to receive a higher rate of interest by reason of their common enterprise than they could receive separately. Thus, the Certificates would be investments in a common venture with the expectation of profits from the efforts of the Sponsors who created the trust, chose its custodian, and would select the banks whose certificates of deposit would comprise the portfolio of each series. For the Certificates to be securities, it is not necessary that the income to be distributed to the investors should come solely from the efforts of the Sponsors. Otherwise, a unit investment trust, which has an unmanaged portfolio of securities issued by others upon whose efforts the production of income of the unit investment trust rests, would not be an issuer and, thus, would not be an investment company; but, of course, a unit investment trust is an issuer and an investment company. Section 4(2) of the 1940 Act. It is sufficient, therefore, that the Sponsors (1) create the opportunity for investors to share in the higher rates of interest available on large denomination certificates of deposit than are available on small denomination certificates of deposit, (2) select the banks whose certificates of deposit will be included in each series, and (3) select the custodian to whom investors will look for payment. In addition, we understand from your representation to Elizabeth Tsai of this office on August 2, 1982, that Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch"), one of the Sponsors, intends to be a primary market maker in the secondary market for the Certificates to facilitate their transfer. This is one more indication of the extent to which investors will be relying upon the efforts of Merrill Lynch for profit.

Based on this analysis, the Staff of the Division of Corporation Finance expressed the view that the certificates were securities that were distinguishable from the instruments comprising the portfolio of CDs to which the certificates related, thus subjecting the offer and sale of the certificates to the registration provisions of the Securities Act, unless a specific exemption was available.

Similarly, in *Morgan Stanley & Co. Inc.*, the Staff was unable to conclude that it would not recommend enforcement action if Morgan Stanley offered and sold certificates evidencing an interest in a guaranteed investment contract or funding agreement without registration under the Securities Act or registration of the trust under the Investment Company Act. The Staff noted that the transaction proposed by Morgan Stanley was not distinguishable from the circumstances considered in the *Gary Plastic* case.

In *Kemper Financial Services, Inc.* (pub. avail. Nov. 29, 1985), the Staff was unable to conclude that it would not recommend enforcement action if Kemper engaged in a program to offer money market demand deposit accounts without registration of the offers and sales under the Securities Act or the registration of the Program under the Investment Company Act. In reaching this conclusion, the Staff particularly noted:

> (1) investors who wish to participate in the Program will give their moneys to Kemper;
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> (2) Kemper will deposit these moneys in MMDAs at banks and thrifts, each of which has contracted with Kemper to accept MMDA deposits of at least $1 million over a one-year period and to pay interest thereon at rates based on a formula determined by Kemper through negotiations with the banks or thrifts;
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> (3) these interest rates will be higher than what the banks and thrifts will offer the public generally;
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> (4) Kemper will select the banks and thrifts and will determine how much to deposit in each after reviewing their financial condition and other factors;

(5) Kemper will monitor the FDIC or FSLIC insurance coverage of these banks and thrifts during the contract life, closing MMDAs at those which have lost or are in danger of losing insurance coverage and depositing them in others;

(6) Kemper may also move deposits if it has reason to believe that another bank or thrift would be more suitable for purposes of the Program so long as this would not violate its contract with any bank or thrift;

(7) investors will not know in which banks or thrifts their moneys are held until after Kemper has deposited them;

(8) Kemper will transfer to a Kemper money market fund moneys in MMDAs with an average daily balance of less than $1,000 so that they will receive a money market rate of return, rather than the lower NOW account rate of interest otherwise payable thereon;

(9) investors cannot deal directly with the banks and thrifts with respect to moneys deposited through the Program; and

(10) if an investor wishes to deal directly with a bank or thrift with respect to such moneys, Kemper will close the MMDA involved and refund the deposit to the investor.

However, it seems reasonable to conclude that a new security will not be deemed to have been created where: the holders of interests will not be involved in any investment contract relationship with the trustee or the financial intermediary as contemplated in the *Gary Plastic* case and the Staff's no-action letters; where no separate or new opportunity for the independent trustee to benefit from or profit from the grouping of the brokered CDs is created; and where the trustee or financial intermediary will serve in strictly a ministerial capacity. Given the appeal of CDs and the desire to diversify exposures, bundled products seem to present interesting opportunities.

Fiduciary Duty: An Update

The Dodd-Frank Act implemented a number of investor protection provisions that affect broker-dealers. Of course, most readers are familiar with Section 913 of the Dodd-Frank Act, which mandated that the SEC conduct a study concerning the effectiveness of current legal and regulatory standards of care for broker-dealers, investment advisers and their associated persons when providing personalized investment advice to retail investors. Broker-dealers are generally not subject to a fiduciary standard of care. By contrast, investment advisers are considered "fiduciaries" who must act in the best interest of their customers. Broker-dealers are currently excluded from the definition of "investment adviser" unless, for example, they charge separately for their investment advice. Although broker-dealers generally are not considered "fiduciaries," they do owe various duties to their customers, such as the duty to recommend "suitable" investments, obtain "best execution" when effecting trades and charge fair commissions or mark-ups for their services. These duties fall short of a fiduciary's requirement to act in the best interests of the client and to avoid placing the interests of the fiduciary ahead of those of the client.

On January 21, 2011, the SEC released the study, which was prepared by the SEC staff. The study does not necessarily reflect the views of the five SEC commissioners who must ultimately decide which, if any, rules should be adopted. Two commissioners dissented from the decision to release the study based on their concern that the study failed to adequately support its position with empirical data. Due to, among other things, this 5-to-2 majority, the study should be viewed as another step towards the likely imposition of a fiduciary standard for broker-dealers.

The study's principal conclusion is that the SEC should establish a uniform fiduciary standard for broker-dealers and investment advisers when providing personalized investment advice to retail customers. Under this standard, both broker-dealers and investment advisers must act in the best interest of their customers; in doing so, they must act without regard for their own financial interest; broker-dealers would be held to a fiduciary standard no less stringent than the existing fiduciary standard for investment advisers under Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 (the "Advisers Act"). The study contemplates that the uniform fiduciary standard would involve both a duty of loyalty and a duty of care. Under the duty of loyalty, a broker or adviser would be prohibited from putting its interests ahead of the customer and would be required to disclose any conflicts of interest. Under the duty of care, a broker or adviser would be held to minimum standards of review and analysis when making investment recommendations or otherwise providing personalized investment advice to retail customers. It is not clear how, if at all, the proposed duty of care would differ from the suitability requirements already imposed on broker-dealers. The study discusses a number of issues that would need to be addressed if the uniform fiduciary standard were adopted, and recommends that the SEC clarify how the standard would be applied through rule-making and/or interpretive guidance. The study also considers and rejects alternative approaches that would have resulted in broker-dealers being subjected to all or most of the provisions of the Investment Advisers Act. The study is short on specifics as to how the fiduciary standard would be implemented and how key terms should be defined. In addition to recommending a uniform fiduciary standard, the study recommends that the SEC consider harmonizing the regulation of broker-dealers and investment advisers in other areas.

As broker-dealers await additional SEC guidance, they must begin to address changes arising in connection with FINRA's adoption of revisions to its rules relating to brokers' "know your customer" and suitability obligations. See our prior issues for updates on these changes here: http://www.mofo.com/files/Uploads/Images/110120-Structured-Thoughts.pdf. In addition, broker-dealers also should consider their relationships with employee benefit plans in light of proposed changes to an ERISA regulation, which could cause them to be considered fiduciaries for ERISA purposes. On October 21, 2010, the Department of Labor issued a proposed regulation that may expand significantly the categories of persons considered fiduciaries as a result of their providing investment advice to plans subject to ERISA or to participants or beneficiaries of such plans. ERISA which subjects fiduciaries to standards of prudence and loyalty to the plans for which they are fiduciaries, as well as to conflict of interest rules, referred to as the "prohibited transaction rules." See our prior report on these proposed changes http://www.mofo.com/files/Uploads/Images/101123-Structured-Thoughts.pdf.

IFLR Derivatives and Structured Products Conference

Morrison & Foerster recently joined IFLR magazine in hosting a conference in London addressing regulatory developments in the United States and in Europe affecting the OTC derivatives market and the structured products market. Tim Hailes, Chairman of the Joint Associations Committee on Retail Structured Products, and Anna Pinedo, partner at Morrison & Foerster LLP, spoke about heightened regulatory scrutiny in relation to structured products targeted at retail investors. A copy of the presentation may be obtained by sending an email to Diane Kolanovic at dkolanovic@mofo.com.

FINRA Rule 5122 Revisions May Affect Certain Structured Products

On January 11, 2011, the Financial Industry Regulatory Authority ("FINRA") issued Regulatory Notice 11-04 (the "Notice") proposing to expand FINRA Rule 5122 to govern all private placements in which a member firm participates—not just those in which the member firm (or its control entity) is the issuer—while retaining all but one of the existing exemptions, including those for offerings sold solely to certain institutions, qualified purchasers and other sophisticated investors. If the amendments are adopted, a member broker-dealer would be required to file the offering document for any private placement in which the member participates, subject to certain exemptions. The expanded rule would incorporate the broad definition of "participation" in FINRA Rule 5110, which corresponds to the types of services typically provided by a broker-dealer in a private placement. FINRA proposes to eliminate the existing exemption under FINRA Rule 5122(c) for offerings in which a member acts primarily in a wholesaling capacity. In making this proposal, FINRA referred to recent enforcement cases involving private placements in which a broker-dealer affiliated with an issuer acted primarily as the wholesaler, as an example of the need for more investor protection. Moreover, given that the proposed amendments expand the rule to reach all private placements, the reliance upon the efforts of an "independent" broker-dealer is no longer relevant. FINRA Rule 5122 would otherwise continue to exempt offerings to institutional accounts, qualified purchasers, qualified institutional buyers (QIBs), investment companies, banks and employees and affiliates of the issuer, as well as offerings under Rule 144A and Regulation S, and offerings of specified types of securities, including commodity pool interests and unregistered investment grade rated debt and preferred securities.

We note that most private placements of structured notes are likely to fall within one of the remaining exemptions. For example, a typical privately placed structured note will fall within the exemption for unregistered investment grade debt securities. In addition, private placements of trust-issued (special purpose entity) structured products, whether or not they satisfy the exemption for investment grade-rated debt and preferred securities, usually are sold to "qualified purchasers," in order to avoid registration under the 1940 Act, and accordingly, will satisfy that exemption.

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