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Structured Thoughts

News for the financial services community.

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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]

[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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