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Structured Thoughts

News for the financial services community.

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Conflicts of Interest

On September 19, 2011, the Securities and Exchange Commission ("SEC") released a proposed rule ("Proposed Rule 127B") implementing the conflicts of interest provisions of Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). Section 621 added a new section 27B to the Securities Act of 1933, as amended (the "Securities Act"). Proposed Rule 127B was released on September 19, 2011, for a 90-day comment period, which will end on December 19, 2011.

As required by new section 27B of the Securities 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 transactions within one year after the date of the first closing of the sale of such ABS that would involve or result in a material conflict of interest with respect to any investor in such ABS.

The term "asset-backed security" is defined in Section 3(a)(77) of the Exchange Act as "a fixed income or other security collateralized by any type of self liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including – (i) a collateralized mortgage obligation, (ii) a collateralized debt obligation, (iii) a collateralized bond obligation, (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the [SEC] by rule determines to be an asset-backed security for purposes of this section." Section 3(a)(77) of the Exchange Act provides that the term asset-backed security "does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company." Although Section 621 of Dodd-Frank was drafted to address principally structured credit and securitized products, the proposed rule relies on the existing Exchange Act definition of "asset-backed security," which may include within its scope structured products that rely on the use of a special purpose vehicle, or a collateralized product. We anticipate that during the comment process the unintended consequences resulting from reliance on the asset-backed securities definition will become clear. For more on the conflicts provision, please see our alert at http://www.mofo.com/files/Uploads/Images/110929-SEC-Proposes-Dodd-Frank-Conflicts-of-Interest-Rules.pdf.

Volcker Rule

Ever since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010,[1] banking organizations (and some nonbank financial institutions) have attempted to determine the breadth and impact of the Volcker Rule. This rule, now section 13 of the Bank Holding Company Act,[2] generally prohibits a covered banking entity ("CBE")[3] from proprietary trading and from investing in or controlling private equity or hedge funds. Long-awaited guidance is now at hand. Earlier this week, the Federal Reserve Board ("FRB"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC") and the Securities and Exchange Commission ("SEC") (collectively, the "Agencies") all approved a proposed regulation (the "Proposed Rule") for publication.[4] The Commodities Futures Trading Commission ("CFTC") is expected to release its own proposal to implement the Volcker Rule in the near future.

The Proposed Rule sweeps more broadly than the Volcker Rule requires, but provides some greater specificity on certain provisions of the Dodd-Frank Act. The Proposed Rule could have a severe impact on trading or fund ownership or control by banking institutions and others. In a very general sense, the Proposed Rule purports to accommodate trading or fund sponsorships for the benefit of, and where the underlying risks are borne by, customers. If any of these activities are not "for" customers—or if a CBE is unable to demonstrate this fact—then the activity is forbidden. Permitted activities are subject to an array of restrictions and compliance requirements.

Of course, the Rule does not address structured products specifically. However, market participants should focus on the effect of the Volcker Rule on the hedging transactions related to structured products, as well as on the effect on market-making activities for structured products. See our alert on the Volcker Rule at http://www.mofo.com/files/Uploads/Images/111014-Volcker-Rule.pdf, and our outline of considerations for derivatives dealers at http://www.mofo.com/files/Uploads/Images/Discussion-Outline-for-the-Proposed-Volcker-Rule-Proprietary-Trading-and-Derivatives.pdf.

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[1] Pub. L. No. 111-203, § 619, 12 Stat. 1376, 1620 (July 21, 2010) ("Dodd-Frank" or the "Act").

[2] 12 U.S.C. § 1851. This provision is Section 619 in Dodd-Frank. We refer herein to Section 13 of the Bank Holding Company Act as the "Volcker Rule."

[3] A CBE is an insured depository institution, its holding company, and any affiliate. Nonbank financial institutions also would become subject to the capital and certain other requirements if and when the Financial Stability Oversight Council ("FSOC") designates them as systemically important. However, the Volcker Rule does not apply the prohibitions on proprietary trading and certain private equity and hedge fund activity to these institutions. These designations may be a while in coming; the FSOC has just begun the rulemaking process for designation. The FSOC proposal for the process is available at http://www.treasury.gov/initiatives/fsoc/Documents/Nonbank%20Designation%20NPR%20-%20Final%20with%20web%20disclaimer.pdf.

[4] The Proposed Rule is available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20111011a1.pdf.

SEC's Staff Legal Bulletin on Legal Opinions

On October 14, 2011, the SEC staff published a legal bulletin (No. 19) that provides guidance on the legality and tax opinions (5.1 and 8.1 exhibits) filed in connection with securities offerings. The legal bulletin memorializes the views taken by the staff in connection with the staff's review of filings. A number of these issues also were raised by the staff with respect to 5.1 legality opinions in connection with offerings of structured products and were discussed in a prior issue of *Structured Thoughts* available at http://www.mofo.com/files/Uploads/Images/110602-Structured-Thoughts.pdf.

As a general matter, a legality opinion must be filed as an exhibit to the issuer's registration statement before it becomes effective, and the opinion cannot be subject to any unacceptable qualifications, conditions or assumptions. The staff legal bulletin confirms that the SEC permits qualified "forward-looking" MTN opinions to be filed at the time of effectiveness of a registration statement, followed by an unqualified opinion either filed at the time of each takedown or included in the text of each pricing supplement related to a specific issuance of notes. The bulletin also addresses the filing of 8.1 tax opinions under certain circumstances, including in connection with registered offerings where "the tax consequences are material to an investor and a representation as to tax consequences is set forth in the filing." Either legal counsel or an independent public or certified accountant can give such an opinion supporting the tax matters and consequences to shareholders described in the filing. A revenue ruling from the IRS also will satisfy this requirement.

Focus on ETFs/ETNs

Since our alert in June 2011 (see http://www.mofo.com/files/Uploads/Images/110607-Structured-Thoughts.pdf) concerning the regulatory scrutiny focused on ETFs, the focus has only intensified. In Europe, a number of regulators have continued to look closely at ETFs. In July 2011, ESMA, the European Securities and Markets Authority, published a discussion paper addressing regulatory and policy guidelines for ETFs and other packaged products. European regulators have focused on concerns related to the complexity of certain of these products, as well as related suitability issues. Many have focused on the use of derivatives or commodities futures by ETFs. Others have focused on market structure or systemic issues that may result from the growth of this market and the development in Europe of the synthetic ETF market. Many of the discussions of ETFs refer more broadly to exchange-traded products and create some potential confusion for investors in distinguishing between ETFs and ETNs. In the United States, there have been a number of Congressional hearings to address market structure issues, and several of these have touched on ETFs. In mid-October, Eileen Rominger, Director of the Division of Investment Management at the SEC, provided testimony on ETFs. Rominger distinguished ETFs from ETNs and helpfully noted the differences as follows:

> Exchange traded notes or "ETNs," which, unlike interests in ETFs, generally are unsecured debt securities issued by public companies, in most cases by bank holding companies or investment banks. ETNs also are exchange-traded securities that can provide the investor with investment exposure to certain market benchmarks or strategies. As ETNs are debt obligations of the issuer of the security, the ETN does not provide the investor with any ownership interest in the referenced security or securities in the referenced index. In addition, an investor in an ETN is exposed both to the market risk of the linked securities or index of securities and the credit risk of the issuer. ETNs do not share the same fund-like or trust-like structure as do other ETPs, and are not registered or regulated as investment companies under the 1940 Act.

However, other participants in the Congressional hearings referred more generally to "exchange-traded products" and seemed to lump ETNs in with ETFs, despite the important differences between these products—especially when considered in light of their impact on trading. We will continue to provide regular updates as regulators move from discussion papers to regulatory action.

Revised FINRA Proposal Applies Content Standards of Rule 2210 to Broadly Disseminated FWPs

On October 31, 2011, FINRA filed a partial amendment to its previous proposals to amend Rule 2210 and Rule 2211, which relate to communications by broker-dealers.[5] The text of the newly proposed amendments may be found at the following link: http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p125035.pdf.

Among other proposed changes to the previous proposal, the new partial amendment would clarify that broadly-disseminated underwriter free-writing prospectuses will be subject to the content standards of paragraph (d) of proposed FINRA Rule 2210.[6] In contrast, documents such as prospectuses and preliminary prospectuses would remain “issuer documents,” to which FINRA would not apply these content standards.

Most broker-dealers currently prepare these documents in an effort to comply with both the guidance of the SEC (and potential liability for misstatements under the securities laws), as well as FINRA’s guidance. Accordingly, this aspect of the proposed amendment may not dramatically affect the preparation of these documents. However, the partial amendment reflects FINRA’s continuing concerns about the adequacy of free-writing prospectuses that are provided to retail investors, and the possibility that FINRA will continue to review these documents.

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[5] For a discussion of the potential impact of these proposals on offerings of structured products, please see the July 27, 2011 issue of Structured Thoughts (http://www.mofo.com/files/Uploads/Images/110727-Structured-Thoughts.pdf).
[6] The content standards require communications, among other things, to be based on principles of fair dealing and good faith, to be fair and balanced, and to provide a sound basis for evaluating the facts in regard to any particular security or service. FINRA’s proposals, as set forth in the link above, would also apply additional content standards.