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Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

HK SFC's New Regime on Unlisted Structured Investment Products

Hong Kong's Securities and Futures Commission (the "SFC") has published rule changes on unlisted structured investment products. This follows a three-month public consultation triggered by the global financial crisis, and in particular by the collapse of Lehman Brothers in 2008. The Hong Kong Monetary Authority ("HKMA") has also conducted a study and introduced rule changes for the banking institutions regulated by it.

The SFC has published its Consultation Conclusions on Proposals to Enhance Protection for the Investing Public and the final form of its Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products. In addition, the HKMA has issued its own circular on Implementation of Pre-investment Cooling-off Period for Retail Customers.

The implementation of the new regimes will include a "mystery shopper" scheme, under which the SFC and HKMA will deploy senior citizens and pregnant women to act as "investors" to monitor compliance with the new rules.

SFC Changes

The SFC's consultation proposals covered investment products and conduct of intermediaries, and spanned the pre-sale, sale, and post-sale phases. The major changes now introduced by the SFC are:

- a consolidated SFC Handbook comprising revised product codes for unit trusts, mutual funds, investment-linked assurance schemes, and unlisted structured investment products;

- a product key facts statement is now required, summarizing the key features and risks of the investment product;
- a post-sale “cooling-off” or “unwind” period for certain unlisted structured investment products with a scheduled tenor of more than one year in respect of which authorization is sought under the SFO; and
- new requirements on intermediaries’ conduct and selling practices relating to the sale of investment products.

Introduction of a consolidated SFC Handbook

The Handbook is a consolidation of the two existing codes on Unit Trusts and Mutual Funds (“UT”) and Investment-Linked Assurance Schemes (“ILAS”) and a new Code on Unlisted Structured Investment Products (the “SIP Code,” formerly known as the Code on Unlisted Structured Products).

The Handbook, effective June 25, 2010, contains a set of overarching principles that will apply across the different types of product governed by it. These are intended to enhance product transparency and to set an overall disclosure standard for all offering documents in respect of different investment products being offered to the public in Hong Kong.

The Handbook also contains new advertising guidelines for unlisted structured investment products and sets out further guidance to issuers of advertisements in respect of all products covered by the Handbook.

Requirement for product key facts statements (“Product KFS”)

Product KFS are intended to serve as concise product summaries, written in plain language, that will help investors understand the key features and risks of the relevant investment product. It is expected that Product KFS should generally be not more than four pages long, and be presented in a format that facilitates comparison with other products.

The basic requirement will be that the Product KFS should be stipulated to form part of the offering document for investment products covered by the Handbook.

The SFC will be prepared to grant an exception in cases where funds adopt uniform global offering documents for distribution in all jurisdictions where their funds are marketed. While the fund issuer in such a case may elect not to stipulate that the fund’s Product KFS forms part of the fund’s global offering document, the issuer would remain subject to applicable laws in Hong Kong imposing civil and/or criminal liability in respect of misrepresentations in the Product KFS.

Post-sale “cooling-off” or “unwind” period

This requirement will apply to unlisted structured investment products with a scheduled tenor of more than one year.

An investor must be given the right to change his/her mind during a “cooling-off” or “unwind” period of at least five business days in Hong Kong after the investor places an order for a structured investment product. The investor will be able to exercise the right in respect of the whole of the order, but not part of it, and such exercise is irrevocable.

Investors are entitled to a refund of, or payment equivalent to, (i) the principal invested less (if applicable) a market value adjustment (including break costs attributable to the unwind or cancellation) and any handling fee, and (ii) a refund of sales charges/commissions, except where the structured investment product has been terminated or has been sold or transferred by the investor prior to exercise of the right. The handling fee must not contain any profit margin for the issuer or the intermediary.

The amount required to be paid or refunded will be capped at the principal amount invested (not including sales charges/commissions). The refund or payment amount must be provided to investors as promptly as practicable after exercise of the right by the investor.

New requirements on intermediaries' conduct and selling practices

The new requirements mainly cover:

- *investor characterization*: as a codification of market practice, an intermediary is required to assess each client's knowledge of derivatives and characterize the client (other than professional investors) based on his knowledge of derivatives

- *pre-sale disclosure of monetary and non-monetary benefits*: specific disclosure on the monetary benefits received by the distributor or its associates as follows:

    - in the form of a percentage ceiling, where a distributor distributes a product and it or an associate explicitly receives monetary benefits from that product's issuer (directly or indirectly), or where a distributor makes a trading profit from a back-to-back transaction

    - in the form of a generic disclosure, where a distributor does not explicitly receive any monetary benefits for distributing an in-house investment product issued by itself or any of its associates, but it or an associate will benefit from the origination and distribution of the product

- *use of gifts by distributors in promoting a specific investment product*: intermediaries will not be allowed to offer gifts (except for discount of fees and charges) for the purpose of promoting a specific investment product to investors

- *disclosure of sales-related information to investors prior to or at the point of sale*: capacity in which a distributor is acting, affiliation with product issuer, monetary and non-monetary benefits received by distributor and discount of fees and charges

- *Product Arranger*: a Hong Kong-regulated Product Arranger will be required for unlisted structured investment products issued by special purpose vehicles and also for unlisted structured investment products where neither the issuer nor the guarantor (if applicable) is Hong Kong regulated

- *indicative valuations*: the requirement for daily indicative valuations has been removed and market-making will be required on a committed basis and for indicative bids to be made on a bi-weekly basis for all unlisted structured products with scheduled tenors of more than six months

HKMA's Changes: Circular on Implementation of Pre-investment Cooling-off Period ("PICOP") for Retail Customers

Whilst the cooling-off and unwinding right prescribed by the SFC for its licensees applies post-sale, the cooling-off arrangement prescribed by the HKMA for authorised institutions ("AIs") regulated by it (i.e., banks, restricted license banks and deposit-taking companies) applies pre-investment.

Under the new arrangement, an AI not only needs to continue to ensure that financial products introduced to its customers are suitable for them and material information in relation to the product (including the nature, risks, indicative price(s), and other terms) is adequately disclosed, it should also allow both elderly and inexperienced customers at least two days to consider their contemplated investment, including whether the investment is appropriate taking into account the nature and risks of the product, their financial ability to assume the risks, and the need to consult third parties.

The price(s) and terms of the transaction will only be fixed on the day when a customer confirms with the AI the placement of a purchase or a subscription order after the PICOP expires.

The PICOP arrangement is mandatory where a customer is aged 65 or above, but the customer will be allowed to opt out from the PICOP arrangement if (i) the customer's asset concentration is below 20% and (ii) the customer is not a first-time buyer of the relevant type of product. For customers aged under 65, PICOP arrangements are only mandatory if (i) the customer's asset concentration is 20% or above and (ii) the customer is a first-time buyer of the relevant type of product.

"Asset concentration" refers to the percentage of a customer's total net worth (excluding real estate properties) to be invested in the relevant transaction, calculated using the nominal amount of that transaction, and an AI may rely on a self-declaration by the customer in ascertaining asset concentration.

PICOP arrangements should be implemented by all AIs on or before January 1, 2011.

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SEC Reviews

On July 16, 2010, the SEC announced that the Division of Corporation Finance will be creating three specialized offices: a disclosure review office to expand enhanced reviews of large financial institutions; an office focused on asset-backed securities and other structured finance products; and an office that will review new securities products and capital markets trends and develop recommendations that will enhance investor protection. We anticipate that this refined focus may result in a closer look at more new structured products.

Summary of Derivatives Regulations

As we have previously noted, the Dodd-Frank Act ("Act") does not directly affect structured products as an asset class; however, the Act's far-reaching changes will impact financial institutions, which are the most active participants in this market, and will impact the derivatives underlying these products. Below is a brief summary of the key provisions relating to derivatives.

Title VII of the Act, to be known as the Wall Street Transparency and Accountability Act of 2010, will impose a comprehensive and far-reaching regulatory regime on derivatives and market participants. Major elements of Title VII are summarized below.[1] However, many sections of Title VII require various studies to be undertaken and mandate or permit significant rulemaking by the Commodity Futures Trading Commission ("CFTC"), the Securities and Exchange Commission ("SEC"), and various Federal banking regulators. As a result, a full assessment of the impact of Title VII will only be possible once that rulemaking advances.

[1] Unless otherwise specified, for convenience we refer to swaps and security-based swaps as "swaps," swap dealers and security-based swap dealers as "swap dealers," and major swap participants and major security-based swap participants as "major swap participants" or "MSPs." We also use the term "applicable regulator" to refer to the CFTC, in the case of swaps, and the SEC, in the case of security-based swaps. For a description of the Act's prohibition on proprietary trading, please see our separate summary of the Volcker Rule.

Lincoln Provision (the "Swaps Pushout" Rule)

– No "Federal assistance" (*e.g.*, advances from any Federal Reserve credit facility or discount window that is not part of a broad-based eligibility program, FDIC insurance, or guarantees) may be provided to any "swaps entity" (*i.e.*, swap dealers and non-bank MSPs).
– The prohibition does not apply to insured depository institutions that limit their swap activities to (i) hedging and other similar risk mitigating activities directly related to their activities and (ii) engaging in swaps involving rates or reference assets that are permissible for investment by national banks. For purposes of the exception in clause (ii), CDS is permissible only if cleared.
– The prohibition only applies to swaps entered into after the end of the transition period, which could be up to five years after enactment.

Regulatory Framework and Key Definitions

– The Act creates parallel regulatory regimes for the CFTC and SEC and divides jurisdiction between the two regulators based on whether a "swap" or a "security-based swap" is involved. The CFTC will have jurisdiction over "swaps" and certain swap market participants, and the SEC will have jurisdiction over "security-based swaps" and certain security-based swap market participants. Banking regulators will retain jurisdiction over certain aspects of banks' derivatives activities (*e.g.*, capital and margin requirements, prudential requirements).
  - ***Swap.*** This term is broadly defined to include many types of derivatives across various asset classes, but excludes, among other things, nonfinancial or security forwards that are intended to be physically settled, futures contracts, listed FX options, debt securities, securities options and forwards that are subject to the Securities Act of 1933 ("33 Act") and the Securities Exchange Act of 1934 ("34 Act"), and security-based swaps. FX swaps and FX forwards qualify as swaps, unless the Secretary of the Treasury determines otherwise; however, notwithstanding any such determination, all FX swaps and FX forwards must be reported to a swap data repository or, in the absence of one, to the applicable regulator, and swap dealer and MSP counterparties to FX swaps and FX forwards must conform to business conduct standards applicable to swap dealers and MSPs.
  - ***Security-based Swap.*** A "security-based swap" is a swap on a single security or loan or a narrow-based security index (generally, an index with 9 or fewer component securities). The definition also includes credit default swaps relating to a single issuer or the issuers in a narrow-based security index.
– The Act creates two new categories of significant market participants: swap dealers and major swap participants.
  - ***Swap Dealer.*** A "swap dealer" is any person who holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties as an ordinary course of business for its own account, or engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. The term excludes persons that enter into swaps for their own account, either individually or in a fiduciary capacity, but not as a part of a regular business. It also does not include insured depository institutions that offer to enter into swaps with their customers in connection with originating loans with those customers. The Act requires the CFTC and SEC to prescribe a *de minimis* exception to being designated as a swap dealer.
  - ***Major Swap Participant.*** A "major swap participant" ("MSP") is any person who is not a swap dealer and:
    - Maintains a "substantial position" (to be defined by the applicable regulators) in swaps for any major swap category, excluding positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;
    - Whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets; or
    - Is a financial entity that is highly leveraged relative to the amount of capital that it holds, is not subject to any Federal banking agency's capital requirements, and maintains a "substantial position" in outstanding swaps in any major swap category.
  - Certain captive finance affiliates of manufacturers that use swaps to hedge commercial risks relating to interest rate and FX exposures are excluded from the definition of major swap participant.

Clearing and Trading Requirements

- ***Mandatory Clearing.*** A swap must be cleared if the applicable regulator determines that it is required to be cleared and a clearing organization accepts the swap for clearing.
  - The determination process may be initiated by the applicable regulator or by a clearing organization, and may relate to any single swap or any group, category, type, or class of swaps.
  - Mandatory clearing requirement will not apply to existing swaps if they are reported to a swap data repository or, if none, to the applicable regulator in a timely manner.
- ***Commercial End User Exception.*** The Act provides an exception to the mandatory clearing requirement if one of the counterparties to the swap (i) is not a financial entity, (ii) is using swaps to hedge or mitigate commercial risk, and (iii) notifies the applicable regulator how it generally meets its financial obligations associated with entering into non-cleared swaps. Application of the exception is at the sole discretion of the commercial end user.
  - The term "financial entity" includes swap dealers, MSPs, commodity pools, private funds (as defined in the Investment Advisers Act of 1940), employee benefit plans, and persons predominantly engaged in activities that are in the business of banking or in activities that are financial in nature, but excludes certain captive finance affiliates. The Act directs the applicable regulators to consider whether to exempt small banks, savings associations, farm credit system institutions, and credit unions.
- ***Mandatory Trade Execution.*** To the extent that a swap must be cleared, it must be executed on an exchange or swap execution facility, unless no exchange or swap execution makes the swap available for trading.
- ***Non-ECPs.*** Persons who are not eligible contract participants ("ECPs") must always enter into swaps via an exchange.
  - For swaps, the illegality applies to the non-ECP.
  - For security-based swaps, the illegality applies to any person effecting the transaction with or for the non-ECP.

Regulation of Swap Dealers and Major Swap Participants

- ***Registration.*** Swap dealers and MSPs must register as such and will be subject to a regulatory regime that will be defined, to a very large extent, by rulemaking. Registration is required with an applicable regulator regardless of whether the entity is registered with the other applicable regulator or is a depository institution.
- ***Capital and Margin.*** The applicable regulators (for non-banks) and the Federal banking regulators (for banks) will set minimum capital requirements and initial and variation margin requirements for swap dealers and MSPs.
  - To offset the "greater risk" of non-cleared swaps, the capital and margin requirements must help ensure the safety and soundness of the swap dealers and MSPs and be appropriate for the risk associated with the non-cleared swaps held by those entities.
  - The Act permits the use of noncash collateral and, for non-cleared swaps, requires swap dealers and MSPs to hold their counterparties' <u>initial</u> margin, upon request, in a segregated account at an independent third party custodian.
  - The Act does not provide an exemption to the margin requirements for commercial end users, although Senators Dodd and Lincoln stated in a June 30, 2010 letter to Chairmen Frank and Peterson their view that the Act does not authorize the regulators to impose margin requirements on commercial end users. Note, however, that imposing margin requirements on swap dealers and MSPs for non-cleared swaps could, in effect, be passed on to end users through swap pricing and/or margin requirements imposed by swap dealers and MSPs.
- ***Business Conduct Standards.*** Swap dealers and MSPs must conform with business conduct standards, including:
  - Disclosure to non-swap dealer and non-MSP counterparties of the material risks and characteristics of the swaps and any material incentives or conflicts of interest that the swap dealer or MSP may have in connection with the swaps; and
  - Additional responsibilities with respect to "special entities" (*i.e.*, States, municipalities, State and Federal agencies, pension plans, governmental plans, and endowments):

- A swap dealer that acts as an advisor to a special entity has a duty to act "in the best interests of" the special entity; and
- A swap dealer or an MSP that offers or enters into a swap with a special entity must comply "with any duty" established by the applicable regulator that requires the swap dealer or MSP "to have a reasonable basis to believe" that the special entity is advised by a qualified independent representative.

Miscellaneous

- The Act increases eligibility requirements for ECPs
- The applicable regulators are authorized to establish aggregate position limits and large trader reporting requirements for swaps.
- Swaps shall not be considered to be insurance and may not be regulated as insurance contracts under State law.
- The SEC is authorized to expand the beneficial ownership rules in sections 13 and 16 of the 34 Act to security-based swaps.
- Offers and sales of security-based swaps to non-ECPs must be registered, notwithstanding sections 3 and 4 of the 33 Act.

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