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Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

The Approach to Developing Common Suitability Standards for the Sale of Complex Financial Products: An Industry View

Background

Following the demise of Lehman Brothers, concerns arose globally relating to the suitability and business conduct standards employed in the sales of financial products, and in June 2009 the Technical Committee of International Organization of Securities Commissions ("IOSCO") announced that it had mandated a standing committee ("TCSC3") to review the suitability obligations that relate to intermediaries' distribution to investors of complex financial products.

Since such time, TCSC3 has been considering such suitability standards in the context of both retail and professional investors and in furtherance of its objectives. It has entered into dialogue with groups of capital markets and industry associations, including the Institute of International Finance, the International Banking Federation, and the Joint Associations Committee on Retail Structured Products (referred to collectively as the "Associations"). At the request of TCSC3, the Associations submitted a written contribution in March 2011 outlining their views on developing common suitability standards for the sale of complex financial products.

Written Contribution and Suggested Principles

The written contribution urged IOSCO to take a careful, targeted, and proportionate approach to developing common standards on suitability. It also recommended that suitability not be defined by reference to the complexity of products, noting that complexity does not necessarily bear any relationship to risk — some noncomplex products can carry higher risks, and vice versa. Instead they recommended considering all securities, as well as collective investment schemes and their related derivative instruments and looking at the balance of risk and reward associated with them.

As set out in greater detail below, the written contribution also provided a list of 18 suggested principles (the "Principles") which the Associations intend to serve as a guide for both conduct by market intermediaries, and the aims of regulators in this area. Such Principles do not focus solely on questions of suitability. Instead, they cover a broader range of issues including disclosure, client categorization, conflicts of interest, and best execution.

The suggested Principles are designed by the Associations to lead to three essential outcomes. First, an investor should be in a position to understand the relevant service or product in all material respects, including its risk/ reward profile, or should be represented by an agent who can understand the service or product. Second, the investor's decision to buy a financial product or service should not be influenced by a material conflict of interest of the provider or adviser. Third, an investor being advised as to a financial product or service should be entitled to expect the adviser to take reasonable care in providing that advice.

The Principles

Those relevant to all stages of the distribution process

1. All customers should be fairly treated, which means the avoidance of conflicts of interest. If conflicts cannot be avoided, they should be mitigated through disclosure.

2. Payments or benefits provided to intermediaries should be clearly disclosed to customers (both in terms of their nature and amount) and must not have a significant adverse effect on the discharge of the intermediary's duties.

3. Intermediaries must disclose all "relevant material information" in a way that is "clear, fair and not misleading." They must respond appropriately to customer requests for information when received. They must make it clear whether or not a communication from them is an investment recommendation.

4. Intermediaries must ensure their staff act in accordance with the Principles, and have resources and procedures in place that allow them to adequately perform their duties. This might include the provision of training and creation of an independent compliance function.

5. Intermediaries must manage their relationships with other firms in the investment distribution chain. This will require giving consideration to whether other firms are "appropriate for their role," ensuring that the roles and duties of each firm in the chain is clear and certain, and that any materials they produce are fair, balanced, clear, and consistent with their obligations.

Principles applicable presale

6. Intermediaries must disclose sufficient information to allow customers to make an informed decision regarding their investment. Such information should include the nature of the service they will provide, the nature of the investments covered by the service, and the basis of their remuneration.

7. Where appropriate, intermediaries should consider telling execution-only clients that it may be in their interests to seek advice.

8. Intermediaries that market investments, or provide personal recommendations or discretionary management, must assess and understand the features, characteristics, and risk/reward profiles of the relevant investments.

9. Intermediaries must seek all relevant information from their customers to help them assess and understand their financial needs, experience, and objectives (unless transacting on an execution-only basis).

Principles applicable at the point of transacting

10. When making investment recommendations to customers, intermediaries should take “reasonable steps” to ensure they are suitable for customers.

11. In taking reasonable steps under principle 10, intermediaries should ensure that: a) the relevant investment is consistent with the customer’s investment objectives, b) the investment will not generate an exposure that is not consistent with the customer’s financial situation, and c) the customer has enough knowledge and experience to understand the features, characteristics, and risks of the investment.

12. Before transacting in respect of an investment with a customer, intermediaries should take “reasonable steps” to ensure that the customer has sufficient information (in a form the relevant customer is likely to understand) to understand the risk/reward profile and other material characteristics of the investment.

13. Principle 12 will not apply when the intermediary is performing a discretionary investment management mandate in accordance with its terms.

14. The basis of any investment recommendations should be communicated clearly to customers, and records of such recommendations should be maintained.

15. If an intermediary is asked by a customer to undertake transactions where it is not providing a recommendation, it should still consider if there is anything that it knows about the customer that clearly suggests that the customer does not have sufficient knowledge or experience to assess the merits of that transaction. If it believes that to be the case, it should (but does not have to) consider whether to notify the customer that it would be prudent to take professional advice. However, if the customer (having been given sufficient time to consider the matter properly) decides to proceed, the intermediary can execute the transaction.

16. Intermediaries should take all reasonable steps to ensure “best execution” on behalf of their customers, subject to complying with the customers’ express instructions. In this context, best execution is to be understood as a term of art, by reference to local usage of that expression.

Principles applicable post transaction

17. Intermediaries should provide information on the performance and value of particular investments with as much frequency and in as much detail as is appropriate in the context of the services they have agreed to provide.

18. In relation to investments acquired as a result of the intermediary’s recommendation, or exercise of discretion, where expressly agreed between intermediaries and their customers, intermediaries should make ongoing assessments of the suitability of investments at such intervals as have been agreed between them.

European Context

Simultaneously with the IOSCO review, the European Commission is currently formulating its proposed legislation in relation to Packaged Retail Investment Products, which will focus on the appropriateness of presale disclosures and the conduct of business obligations of the providers and distributors of financial products and services, based on the standards established in the Markets in Financial Instruments Directive. Many of the Principles bear a close resemblance to MiFID conduct of business obligations and the way in which those obligations have been developed by member state competent authorities, such as the FSA in the UK.

Similar to the PRIPs initiative,[1] the Principles aim to apply those conduct of business obligations in a consistent (though not homogenous) way across different financial product and sector groups. It is also worth noting that the current MiFID review by the European Commission[2] aims to extend certain conduct of business obligations (such as in relation to pre-trade transparency) that apply to equity securities, to other securities and derivatives products within the scope of MiFID. In Europe, the aim is clear — bringing disclosure and conduct of business requirements up to the highest standards that exist across all different sectors and products. We wait to see whether IOSCO will adopt a similarly broad-reaching aim.

"Principal protected:" Fair, clear, and not misleading? UK guidance on promotions of structured products

In the UK, Rule 4.2.1 of the FSA's Conduct of Business Sourcebook ("COBS") provides that a firm must ensure that a communication or a financial promotion within the scope of that Rule is fair, clear and not misleading. This will generally apply to financial promotions communicated to retail clients and is to be read in conjunction with Rule 4.5.2 of COBS, which provides that information for retail clients must be "sufficient for, and presented in a way that is likely to be understood by, the average member of the group to whom it is directed, or by whom it is likely to be received."

In October 2009, the Financial Services Authority ("FSA") published a report (the "Report") summarizing its findings following a review into the financial promotions of structured investment products. Among other things, the Report highlighted a concern that financial promotions often made prominent claims that investments were "secure," "safe," "protected," or "guaranteed," without clearly and unambiguously explaining what such terms mean. As a consequence, the FSA felt that use of these terms has not always been "fair, clear and not misleading." Some examples of misleading descriptions were given by the FSA.

In relation to products where some or all of the investor's capital is at risk, describing the risk in terms of "contingent protection" or similar was considered misleading, particularly where there is a prominent claim of "capital security" and a less prominent and insufficient explanation of when capital can be lost. The FSA considered that describing such a product as "safe" or "secure" undermined the message that capital could be lost, and therefore breached the FSA's Rules. The FSA also considered that the same view could be taken of the use of the word "protected" for such products, unless the limits of the protection were very carefully explained.

Even in relation to products where the issuer is obliged to return capital in full on maturity, the FSA still considered that the use of terms such as "safe" or "protected" require an explanation that the investor is protected from market risk at maturity, but not counterparty risk, i.e., the risk that the issuer is unable to pay what it is obliged to pay at maturity, and what this risk means for the investor.

For any product described as "guaranteed," the FSA was concerned that this terminology gives the impression of a guarantee or assurance by a third party, and if there were in fact no third party obligor, the FSA considered this terminology misleading. Where there is a third party guarantor, there should be a clear explanation of who provides the guarantee and what its limitations might be, for instance when it is provided by a member of the same group of companies as the issuer.

[1] See Structured Thoughts Vol. 1, Issue 18 http://www.mofo.com/files/Uploads/Images/101217-Structured-Thoughts.pdf.
[2] See MoFo Client Alert http://www.mofo.com/files/Uploads/Images/101221-European-Commission-Consultation-on-the-Review-of-MiFID.pdf. Draft legislation is expected from the European Commission in October 2011.

Where a third party provides capital protection on maturity, for instance via a guarantee or by issuing a bond or other instrument to the issuer, the FSA also found that a large proportion of the financial promotions it reviewed were ineffective at describing the counterparty risk, in relation to that third party, to which investors were exposed.

Following on from the Report, the FSA has, in Appendix 5 to its most recent quarterly consultation paper,[3] proposed making amendments to COBS[4] and Banking: Conduct of Business Sourcebook (BCOBS),[5] (which contains similar provisions to COBS in respect of fair, clear, and not misleading communications) to provide explicit guidance in this context.

The proposed guidance states that the words "guaranteed," "secure," "protected," or similar language should not be used in promotions of financial products unless (i) the term used is capable of being a fair, clear, and not misleading description of the product's features and (ii) the firm communicates all information necessary, and in a sufficiently clear and prominent manner, to make the use of the term fair, clear, and not misleading.

Comments are invited on the proposed guidance up until August 6, 2011.

UIT Basics

A unit investment trust, which is a type of registered investment company under the Investment Company Act of 1940 (the 1940 Act), may be used as a means of offering structured investments. This section offers some UIT basics.

The 1940 Act defines a UIT as "an investment company which: (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues redeemable securities, each of which represents an undivided interest in a unit of specified securities . . . ." A UIT may be organized as a single trust, or as a series trust. Each UIT must have a fixed termination date — usually between one and 30 years, depending on its underlying portfolio. As an investment company, a UIT is required to hold "securities" as defined under the 1940 Act, which may, for example, include debt securities as well as certain derivatives that are considered "securities" under the 1940 Act. A UIT invests in a fixed portfolio of securities. The portfolio is passive — it may not be actively managed by an adviser or the sponsor (unlike a mutual fund). There is no seasoning requirement for the underlying securities; the UIT may purchase securities for deposit in the trust as part of an initial distribution.

Creation

Unlike other investment companies, a UIT must file two separate forms in order to comply with the requirements of the Securities Act of 1933, as amended (the Securities Act) and the 1940 Act. Under the 1940 Act, the UIT must file a Form N-8B-2. This form is only amended when there is a material change to the UIT affecting the content of the form. This form is subject to review by the SEC and must include: (1) a summary of the material terms of the indenture and other contracts into which the trust has entered; (2) a description of the securities offered; (3) a description of all sales loads, fees, and charges and expenses; (4) information regarding the sponsor, including its history and operations, and its officers, directors, and employees and their compensation; (5) any distribution arrangements; (6) information regarding the trustee, custodian, and any other service providers; (7) information regarding portfolio insurance, if applicable; (8) tax consequences; and (9) audited financial statements. Review by the Division of Investment Management of the SEC can take longer than review by other areas of the SEC, such as the Division of Corporation Finance.

[3] CP11/11 http://www.fsa.gov.uk/pubs/cp/cp11_11.pdf.
[4] COBS 4.2.5.
[5] BCOBS 2.2.5.

Redemption Options

A UIT must issue redeemable securities. The term "redeemable securities" is defined in Section 2(a)(32) of the 1940 Act as "any security other than short-term paper, under the terms of which the holder upon its presentation to the issuer (or someone designated by the issuer) is entitled (whether absolutely or out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof." A UIT must make redemption available on a daily basis. If units are redeemed for their cash value, the 1940 Act requires that they be redeemed at net asset value, or NAV. For these purposes, NAV would be calculated on the date the trustee receives the redemption notice.

Secondary Market

In practice, it is typical for a sponsor to maintain a secondary market in the units. This provides investors with liquidity and avoids a depletion of the UIT's assets due to redemptions. The SEC considers a sponsor making a market in a UIT's securities to be the "issuer" of those securities. As such, the sponsor is required to keep current the registration statement in connection with any secondary market sales and must deliver a prospectus in connection with such sales. Sales in the secondary market will be made at NAV – the sponsor will not make a bid-offer spread on the securities.

Section 22(d) of the 1940 Act and Rule 22c-1 thereunder require that investment company redeemable securities be sold at NAV. Because of this requirement, it is not possible to list units of a UIT on a national securities exchange because the market price may not equal NAV. However, the SEC frequently grants exemptive relief to a UIT in order to list its securities on a national securities exchange.

Prohibitions on Affiliated Transactions

There are a number of prohibitions under the 1940 Act, specifically Section 17, that limit the ability of an investment company to transact with its affiliates. These sections generally are applicable to a UIT.

Prohibitions on Transactions with Broker-Dealers

Section 12(d)(3) of the 1940 Act makes it unlawful for any registered investment company (and any company or companies controlled by such company) to purchase or otherwise acquire any security issued by . . . any person who is a broker, a dealer, is engaged in the business of underwriting . . . unless: (A) such person is a corporation all the outstanding securities of which are, or after such acquisition will be, owned by one or more registered investment companies; and (B) such person is primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, or any one or more related activities, and the gross income of such person normally is derived principally from such business or related activities.

Rule 12d3-1 provides certain limited exemptions from this restriction. This rule allows a registered investment company to acquire any security issued by any person that derives more than 15% of its gross revenue from securities related activities, provided that: (1) immediately after the acquisition of any equity security, the acquiring company owns not more than 5% of the outstanding securities of that class; (2) immediately after the acquisition of any debt security, the acquiring company owns not more than 10% of the outstanding principal amount of the issuer's debt securities; and (3) immediately after any such acquisition, the acquiring company has invested not more than 5% of the value of its total assets in the securities of the issuer. Because none of these triggers would be met, the acquisition of the Call Option by the UIT would not be prohibited by Section 12(d)(3).

In addition, Rule 12d3-1 prohibits the acquisition of a security issued by, among others, the acquiring company's promoter, principal underwriter, or any affiliated person of such promoter or principal underwriter. However, the

SEC has permitted an affiliate of the primary underwriter of a registered investment company to sell to the registered investment company over-the-counter put options.[6]

Tax Considerations

For federal income tax purposes, a UIT may either be structured as a grantor trust or a RIC. A grantor trust is a complete pass-through entity and is not subject to tax at the entity level. Owners of a grantor trust are treated as owners of pro rata undivided beneficial interests in the trust's assets and income. To qualify as a grantor trust for federal income tax purposes, the trust must qualify as an "investment trust" under applicable Treasury regulations.[7] To qualify as an investment trust, the trust (i) must have a single class of ownership interests,[8] and (ii) there must be no "power to vary the investment" of trust holders under the trust agreement.[9] A violation of either requirement generally should result in the reclassification of the "trust" as a partnership for federal income tax purposes. Alternatively, the UIT may be structured as a registered investment company (a "RIC"). In order to qualify as a RIC for federal income tax purposes, the UIT would be subject to certain asset diversification requirements. In addition, to avoid an entity-level tax, a RIC also is subject to strict income distribution requirements.

Securities Act Registration Process

A UIT has two options under Section 24 of the 1940 Act for registering its securities. The UIT may register either a finite number of units or it may register an indefinite number of units initially. If the UIT registers an indefinite number of units, it must pay, within 90 days of the close of each fiscal year, the registration fee for the units sold during that year (less units redeemed or repurchased).

Initial Filing

The UIT must file a Form S-6 with the SEC to satisfy its Securities Act filing obligations. Each series of a UIT is considered a separate registrant and must file its own registration statement on Form S-6 to register the series of the trust and the securities being offered as part of that series. Each series also must prepare its own preliminary prospectus, which is used by the underwriting syndicate to obtain indications of interest for the units. The Form S-6 generally requires disclosure, in a prospectus, of information similar to that required in the Form N-8B-2. The initial filing on Form S-6 is subject to review by the SEC and is treated as an initial public offering of the UIT. Any subsequent Form S-6 filed for a series of the UIT is not subject to full review, as discussed below, because of the implementation of Rule 487; however, the SEC may review the performance data (if any) contained in such filings.

Additional Series

A UIT may not avail itself of the ability to conduct continuous or delayed offerings under Rule 415; there is no "shelf registration" process for UITs (or for any registered investment company). However, if a UIT is organized as a series trust, Rule 487 provides some flexibility for conducting subsequent offers. The initial series of the trust must file a registration statement, and this registration statement is subject to review by the SEC. However, once the SEC has declared effective the registration statement, the UIT may rely on Rule 487 for future offerings. Rule 487 permits the registration statement relating to a subsequent series of a UIT to become effective automatically without affirmative action by the SEC. In order to avail itself of Rule 487, the UIT must satisfy a number of conditions. The

[6] *See* SEC Release No. IC-26063.
[7] Section 301.7701-4(c)(1). Unless otherwise indicated, references to "Sections" are to the Code and to the Treasury Regulations promulgated thereunder.
[8] Section 301.7701-4(c). However, an investment trust may have multiple classes of ownership in limited circumstances. Specifically, multiple classes may exist if such classes are formed to facilitate a direct investment in the trust's assets and the existence of such classes is merely incidental to such purpose.
[9] *Id*. While neither the Code nor Treasury Regulations define what constitutes a power to vary the trust's investments, the position of the Internal Revenue Service ("IRS") is that such power exists where "the trustee, or some other person, has some kind of managerial power over the trusted funds that enables him to take advantage of variation in the market." Rev. Rul. 75-192, 1975-1 C.B. 384.

UIT must identify one or more prior series of the trust that the SEC has declared effective. The UIT also must represent that the securities deposited in the new series being registered do not differ materially in type or in quality from those deposited in the prior series and the disclosure in the prospectus for the series being registered may not differ materially from the disclosure in the prior series' registration statement. In addition, the UIT must deliver a preliminary prospectus in compliance with Rule 460 (delivery to underwriters). This process will have the effect of permitting frequent offers by series of the trust on an expedited basis.

Ongoing Obligations

Exchange Act Reporting

A UIT is subject to ongoing reporting obligations under the Exchange Act. A UIT is permitted to satisfy its periodic reporting obligations under the Exchange Act by filing a Form N-SAR, which is an annual report. Each UIT is required, under Rule 30a-1 of the 1940 Act, to file an annual report on such form within 60 days after the close of each calendar year. The sponsor would prepare the annual report on behalf of the UIT. The Form N-SAR is required to disclose information regarding, among other things, sales during the period, affiliated transactions, sales loads, and other fees. The Form N-SAR is not required to contain audited financial statements. UITs are exempt from the certification requirements of Section 302 of Sarbanes-Oxley (principally because they do not provide holders with annual reports containing financial statements). In practice, however, the trustee typically will provide an annual report to holders, detailing the activities of the trust. This report customarily contains audited financial statements and the trust's management's discussion of fund operations, investment results, etc.

In addition, the 1940 Act permits only a limited ability to incorporate future filings by reference, so the registration statement must be amended or supplemented in order for it to be kept current.

Ongoing Maintenance Costs

The UIT may bear the cost for certain organizational expenses, including preparing and printing the registration statement and organizing trust documents, registration of units, and the initial audit. All other expenses must be borne by the sponsor. In addition to the organizational responsibilities discussed above, a sponsor also typically performs ongoing services for the UIT. In particular, the sponsor is entitled to receive a fee for providing portfolio supervisory services, maintaining unit holder records, updating the registration statement, and audit services.

Contacts

Peter J. Green
+44 20 7920 4013
pgreen@mofo.com

Jeremy C. Jennings-Mares
+44 20 7920 4072
jjenningsmares@mofo.com

Lewis Gavin Lee
+44 20 7920 4071
lewislee@mofo.com

Anna Pinedo
(212) 468-8179
apinedo@mofo.com

Morrison & Foerster named Structured Products Firm of the Year, Americas, 2011 by *Structured Products* magazine.

Morrison & Foerster short-listed for *Derivatives Week* magazine's 2011 Law Firm of the Year. The winner will be revealed at a ceremony on September 27, 2011.

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