

# Structured Thoughts

*News for the financial services community.*



## Regulating Retail Structured Products—The IOSCO Toolkit

The regulation of retail structured products in established markets such as in Europe and the United States is not a new concept. Since the onset of the financial crisis and the collapse of Lehman Brothers in 2008 (and even in some cases, beforehand), several common regulatory themes have developed across a number of jurisdictions. These include the desire to eradicate irresponsible selling, rebuild investor confidence, improve transparency and simplify unnecessary complexity. However, the precise focus of different regulators and the techniques they use to regulate this market can be widely divergent. This has prompted the attention of the International Organization of Securities Commissions (“IOSCO”).

IOSCO’s Task Force on Unregulated Markets and Products established a Working Group on Retail Structured Products, consisting of (amongst others) the Financial Services Authority (“FSA”) in the UK, the Securities and Exchange Commission (“SEC”) in the United States and the Financial Services Agency in Japan. Their work, as well as the results of a survey conducted across the entire IOSCO membership, now forms the basis of a consultation report (the “Consultation”)<sup>1</sup> in relation to a possible ‘regulatory toolkit’ for retail structured products<sup>2</sup>.

The purpose of this toolkit is to provide guidance to IOSCO members in respect of potential regulatory responses when dealing with future market challenges. However, IOSCO expressly does not intend any of the “tools” to be mandatory, or necessarily even desirable, in all cases. As such, the toolkit seems to be only a discussion of the

<sup>1</sup> IOSCO, Regulation of Retail Structured Products, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD410.pdf>.

<sup>2</sup> For those of us who have an interest in comparative legal studies and structured products legal minutiae, the Consultation also provides an extremely interesting survey of existing structured products regulation in a variety of countries, from the Maldives to Lithuania. We have resisted the temptation to summarise in this article the regulatory regime in all of those jurisdictions.

universe of regulatory approaches that could be applied to retail structured products.

The regulatory toolkit breaks down into five primary areas:

- suggested overall regulatory approach to retail structured products (the “value-chain” approach);
- product design and issuance;
- product disclosure and marketing;
- product distribution; and
- post-sales practices.

This update summarises the primary apparatus in IOSCO’s toolkit for each of the areas outlined above, and reflects upon their consistency with existing and proposed regulations in Europe and the United States.

### **A Value-Chain Approach**

IOSCO suggests that any approach to structured products regulation adopted by its members should take into consideration the entire ‘value-chain’ *i.e.*, the relationships involved in the life of the product, from the issuance of the product to its distribution, to the investment by the end investor. “Issuance” is intended to include both the origination and manufacture of the product, while “distribution” incorporates the definition from IOSCO’s final report on suitability requirements (the “IOSCO Suitability Standards”)<sup>3</sup>, including “*in broad terms the services of selling by the intermediary including marketing, selling, advising, recommending and, where relevant, managing discretionary accounts / individual portfolios, which results in holdings by customers of complex financial products*”.

In order to minimise the opportunities for regulatory arbitrage, IOSCO suggests that regulators consider taking a “horizontal” approach to regulation that is not determined by the base instrument (or “wrapper”) of the product, nor the type of underlying reference asset for the product. This is an approach which, at least in Europe, has formed the basis of regulatory focus in this area since 2009<sup>4</sup>, as is reflected in the current draft of the proposed PRIPs regulation<sup>5</sup> and certain proposed changes to the MiFID Directive<sup>6</sup>.

IOSCO also encourages its members to consider aligning their activities and approach with those of other regulators, both within and outside their jurisdiction.

### **Product Design and Issuance**

#### *Investor Identification and Assessment*

In IOSCO’s view, product issuers could be encouraged or made responsible for the identification and assessment of types, classes and features of investors at whom they wish to target their structured products. Such information might also be disseminated (where possible) to distributors for their use, in order to help ensure that products end up in the intended hands. Examples of possible regulatory requirements include (but are not limited to) a requirement to thoroughly analyse investor needs (considering investor risk profile, tolerance for loss of capital, investment objectives and investment

<sup>3</sup> IOSCO, Suitability Requirements With Respect to the Distribution of Complex Financial Products, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD400.pdf>.

<sup>4</sup> The European Commission issued a communication ([http://ec.europa.eu/internal\\_market/finservices-retail/docs/investment\\_products/29042009\\_communication\\_en.pdf](http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/29042009_communication_en.pdf)) to the European Parliament referencing the need for a ‘horizontal approach’ that encompassed the production of key disclosures by product manufacturers of packaged retail investment products, as well as the selling of these products by intermediaries or other distributors (including the product originator).

<sup>5</sup> Regulation on key information documents for investment products: [http://ec.europa.eu/internal\\_market/finservices-retail/docs/investment\\_products/20120703-proposal\\_en.pdf](http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/20120703-proposal_en.pdf).

<sup>6</sup> In the U.S., a variety of different regulators may be involved, depending upon the “wrapper”: the SEC, FINRA, the Office of Comptroller of the Currency and a variety of federal and state banking and securities regulators.

timeframe), to promote investment products in a way that can be easily understood and to consider the financial, experience and education of the target market<sup>7</sup>.

Having a detailed understanding of the recommended target market for particular products is intended to assist distributors when making required suitability assessments. If products are designed with a particular class of investors in mind, they are believed to be more likely to be suitable for a member of that class. It is worth noting IOSCO's view here, that financial intermediaries should be separately required (by rules drafted along lines recommended by the IOSCO Suitability Standards), amongst other things, to (a) distinguish between retail and non-retail customers when distributing complex financial products (Principle 1), (b) check that the structure and risk-reward profile of a financial product is consistent with a customer's experience, knowledge and investment objectives (Principle 5) and (c) have a reasonable basis for any recommendation, advice or exercise of investment discretion made to a customer when distributing complex financial products (Principle 6). The creation of target investor identification rules and rules relating to an assessment of suitability (on a generic basis only) by the product manufacturer for target investors are intended to dovetail with these principles applicable to intermediaries.

As with a number of other items in the toolkit, it should be noted that the investor identification and assessment recommendations of IOSCO are already integrated into the regulatory regimes of certain individual jurisdictions such as the UK. In March 2012, the FSA published finalised guidance (the "UK Structured Product Guidance") on retail structured products<sup>8</sup>, providing that "*identification of a target market is crucial, not only for generating ideas for products, but for avoiding failures later in the value chain...consideration of the target market should permeate all aspects of the product development and distribution*". In the U.S., FINRA has been quite active in ensuring that broker-dealers appropriately review these issues. The IOSCO toolkit appears to endorse this view and recommends consideration of a similar approach to each of its members.

#### *Use of Financial Modeling*

Product issuers could be required to use financial models, including so-called 'value-for-money' tests, to performance-check potential products before they are sold to investors. The suggestion here is that such methods can stress-test a product and help inform any internal product approval processes. However, IOSCO goes further in suggesting that issuers might be required to disclose the modeling results to investors. This concept is likely to give rise to some concerns, particularly where such information might be relied on by investors excessively, or for the wrong purpose. In fact, IOSCO itself highlights a number of other potential issues, including whether investors are always capable of understanding any results produced and/or whether there is a potential risk of investors being misled by incorrect or inappropriate assumptions and in the U.S., such information needs to be viewed in light of FINRA's recent statements that certain types of "backtested" information may be inappropriate for retail investors<sup>9</sup>.

The suggestion that members implement financial modeling requirements, however, will involve the consideration of further technical guidance to make the proposals workable. In the UK Structured Product Guidance, for example, broad consideration has been given to the types of financial modeling that would be appropriate for different structured products. Simulations, for example, are considered appropriate when determining expected profitability from an investor's perspective, but different simulations should be used for different products. With respect to structured deposits, for example, cash comparison tools are considered appropriate, while more volatile underlyers such as equity indices require forecasting measures. That said, IOSCO's suggestions do serve to open the debate regarding the value of financial modeling and the associated risks.

#### *Internal and/or Regulatory Approval Process*

IOSCO considers that its members should contemplate focusing on certain elements of this internal approval process for new products. From an internal approval perspective, the intention is to maintain focus on the development stages of the

<sup>7</sup> In the U.S., these concepts are reflected in the suitability requirements that FINRA imposes on broker-dealers. However, the entities that issue the structured products are generally not required, as a legal matter, to consider them. Of course, many issuers do consider these issues, for reputational and other reasons.

<sup>8</sup> FSA, Retail Product Development and Governance – Structured Product Review, <http://www.fsa.gov.uk/static/pubs/guidance/fg12-09.pdf>. Please also see Morrison & Foerster Structured Thoughts, Volume 2, Issue 15, <http://www.mfo.com/files/Uploads/Images/111205-Structured-Thoughts.pdf>.

<sup>9</sup> See FINRA's April 2013 interpretive letter at <http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P246651>.

value-chain, such that concerns can be highlighted before opportunities are presented to investors. An effective internal governance process is vital to ensure that adequate safeguards and controls are in place to protect investors. Examples might include (amongst other things) the development of appropriate product design systems, procedures and controls, the creation of policies designed to prevent conflicts between the interests of employees and investors, and the concept of product design that can stand up to scrutiny and challenge from an investor perspective. Such requirements can already be found in the UK Structured Product Guidance, as well as in broker-dealer requirements mandated by FINRA<sup>10</sup>.

IOSCO also suggests that an appropriate regulatory approval process might potentially mandate a requirement that all new financial products must be pre-approved by an appropriate regulatory body. The suggested advantages of this approach are that regulators would receive greater knowledge and understanding of the products being sold and would be able to ensure that products would meet requisite standards before finding their way into the hands of investors. However, it seems very unlikely, at least in the UK and the United States, that there is significant appetite to enforce a potentially costly and time consuming regulatory approval process that would further restrict liquidity and choice in the market for structured products, and potentially prevent the introduction of new and useful products on a timely basis<sup>11</sup>. This is particularly true if other safeguards referred to in the IOSCO toolkit or elsewhere are deemed to be sufficient.

Quite apart from the issues of the resources needed to implement such a process, there is the very real problem of moral hazard—the impression that may be gained by investors that pre-approved products were “safe” for them to invest in and that they could reduce or abandon the due diligence efforts that they might otherwise employ in reaching an investment decision.

### *Product Standards*

Another element of the toolkit that has already received considerable attention in countries such as Belgium and France, is the potential requirement to establish fixed, pre-determined criteria and standards applying to investment products. This is particularly relevant in respect of sales to retail investors. Examples might include the setting of minimum capital requirements for issuers and/or guarantors, or restrictions based on the complexity of a product or the extent to which it must be capital protected. In Belgium, for example, a voluntary moratorium was put into effect in August 2011 on all ‘particularly complex’ products<sup>12</sup>, until legislation derived from the results of a thorough consultation has been put in place. Market concern exists in respect of these types of controls, however, and the risk that they might serve to slow product innovation and diversity. Issues may also arise where the focus of the product standards is potentially misplaced. Given the Belgian example, some commentators feel that an over-emphasis on complexity masks an appropriate analysis of the direct risks associated with the products themselves, and that many regulators may not appreciate the difference between complexity and risk.

The risk of moral hazard is present here as well, in that a product which complies with the restrictions could be regarded by some investors as safe to buy without further investigation.

## **Product Disclosure and Marketing**

### *Disclosure Standards and Summary Disclosure*

Disclosure standards with respect to retail structured products are critical for ensuring that investors are in a position to make informed decisions, and IOSCO’s suggestions for regulators include alignment of disclosure standards to ensure their consistency with an investor’s ability to understand the disclosure and mandating the disclosure of all ‘essential’ information to assess a relevant product. As a separate tool, IOSCO refers to the possible need for short-form or summary disclosure, either to be provided separately, or as part of a broader disclosure document, particularly where the disclosure document is lengthy. In this regard, the use of templates to standardise disclosure is mentioned as a possibility. Any such summary disclosure is envisaged to include (amongst other matters) product description, potential downside risks, details of any applicable guarantees, scenario analysis, risk indicators, secondary market opportunities and comparisons to alternative investment products. The aim here would be to facilitate benchmarking and generate

<sup>10</sup> See, for example, NASD Notice to Members 05-26 relating to new product approvals.

(<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p013755.pdf>).

<sup>11</sup> See the FSA’s views regarding product pre-approval at Page 49: [http://www.fsa.gov.uk/pubs/discussion/dp11\\_01.pdf](http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf).

<sup>12</sup> See FSMA FAQ’s on the moratorium: <http://www.fsma.be/en/in-the-picture/Article/nipic/faqa.aspx>.

comparisons against other products, to the extent that this is possible. In the U.S. and many other markets, many issuers have made significant efforts to customize their offering documents to their own respective styles, which they often believe helps facilitate an investor's understanding. These institutions might be most likely to reject the notion of a standardized format.

Given that in many jurisdictions including the EU and U.S., detailed disclosure standards are already embedded in existing legislation, this particular aspect of the toolkit is perhaps more relevant to less-developed markets. In Europe, the prospectus disclosure regime has recently undergone a significant overhaul, applying in circumstances where non-exempt offers of securities (including retail offerings) are made to the public and setting out detailed criteria in respect of the minimum amount of information to be disclosed, as well as the format in which it has to be presented. The Prospectus Regulation<sup>13</sup> specifically requires that in addition to any summary that should be contained within a base prospectus (applicable to programme offerings), an issuer-specific summary should also be prepared and attached to the deal-specific terms of every retail issuance. Further, the proposed EU PRIPs regulation is currently paving the way for the introduction of a template Key Information Document (KID)<sup>14</sup>. This is intended to provide information disclosure in a standardised format for packaged retail investment products. It still remains to be seen whether this requirement will be extended to include all retail structured products (and not just PRIPs) in the future. In the U.S., many prospectuses are designed to provide user-friendly summaries on their cover page and initial pages in accordance with Items 501 and 503 of Regulation S-K. In addition, many issuers have introduced various types of summary term sheets and free writing prospectuses that are designed to be as concise and helpful as possible.

One point on which IOSCO is silent, in this regard, is the standard of care/liability attaching to such short form disclosure and whether (if it is provided in addition to the main disclosure document to aid understanding/comparability of products) it should attach any liability at all for the issuer. If so, should that liability be at the same or a lower level than liability for the main disclosure document<sup>15</sup>?

IOSCO also suggests the possible introduction of additional techniques, such as the disclosure of risk indicators. Risk labeling in certain jurisdictions such as Denmark has featured as a regulatory tool for some time, although as noted by IOSCO, concerns exist that implementing static indicators that are not aligned to investor profiles will be too broad and inflexible to be of anything more than limited assistance, as well as running the risk of investors attaching too much importance to the indicator and too little importance to their overall understanding of the product.

#### *Costs and Fees*

The toolkit also contains a requirement for full disclosure of fees and costs levied in the context of retail structured products. One suggestion is to require full disclosure of costs on a disaggregated basis, including explicit costs, such as commissions, and implicit ones, such as the costs and premia effectively charged on the individual component parts of the product. Such unbundling is intended to aid comparability across products by increasing transparency. Alternative considerations which are not referred to in the IOSCO toolkit, include the approach taken by the UK FSA in its Retail Distribution Review, which has been in place since the beginning of 2013. Here, amendments to adviser compensation rules have resulted in the banning of payments of commissions from third parties with respect to advised sales. The ban is intended to prevent advisers from making recommendations which are overly-influenced by the commission payable on the product. Similar rules are expected at an EU level once the legislation amending and supplementing the Current Markets in Financial Instruments Directive is finalised.

#### *Fair Value Assessment*

IOSCO's toolkit also refers to the possibility of requiring the disclosure to investors of the estimated fair value of a product upon issuance. This, it is suggested, would provide a guide to investors of what the product might be worth post-issuance.

<sup>13</sup> Prospectus Directive Regulation (EC) No 809/2004.

<sup>14</sup> Proposal for a Regulation on key information documents for investment products:  
[http://ec.europa.eu/internal\\_market/finances-retail/docs/investment\\_products/20120703-proposal\\_en.pdf](http://ec.europa.eu/internal_market/finances-retail/docs/investment_products/20120703-proposal_en.pdf).

<sup>15</sup> In contrast, in connection with its 2005 "Securities Offering Reform," the SEC made an attempt to clearly articulate the potential liabilities involved in these short-form documents, and the liable parties.

As to this issue, current developments in the U.S. market may influence regulation in other jurisdictions. In the SEC's April 2012 "sweep letter" and its related follow-up letter in February 2013, the SEC set forth its position that offering documents for registered offerings of structured notes should contain the issuer's estimated value of the instrument. Following a (quite arduous) series of written submissions and meetings with the SEC, as of the date of this article, several major U.S. issuers have introduced these disclosures into their prospectuses, and additional issuers are expected to do so as well. Non-U.S. regulators will have an opportunity to wait and see how these disclosures impact the U.S. market, if at all, before taking any action.

### *Hypothetical Scenarios and Backtesting*

Other recommendations provided by IOSCO include the requirement to set out hypothetical scenarios, using formulae to disclose examples of the way in which a particular product may generate a return. The suggestion is that by presenting each of a positive return, negative return and break-even scenario, an investor is better equipped to understand the mechanics of a particular pay-out structure<sup>16</sup>. Likewise, the toolkit considers the additional disclosure of backtesting, whereby the scenarios are run using historical information. IOSCO accepts, however, that backtesting may not be applicable to short-term products and that significant care must be taken to ensure that disclosures are not misleading (for instance, as a result of the particular selection of historical information)<sup>17</sup>. A range of different data sets could be used to show the product's volatility, although concerns exist about the ability of investors to understand what conclusions to draw from the information, depending upon how the range of data is presented.

### **Product Distribution**

#### *Control Over Distribution Channels by Issuers*

In broad terms, IOSCO suggests that issuers could be made responsible for the way in which products are distributed to consumers. This might involve issuers putting in place distribution strategies that are tailored to an intended target market and obtaining undertakings from intermediaries to ensure that complex products are only sold based on recommendations from distributors who can demonstrate a high degree of competence, based on enhanced qualifications<sup>18</sup>. Using collected data relating to the performance of distribution channels, IOSCO considers that issuers would be better placed to '*detect patterns in actual distribution compared to expected distribution*'. Issuers may then be expected to act on any concerns they might have.

Interestingly, when the UK FSA assessed seven major providers of retail structured products between 2010 and 2011 in the context of informing the UK Structured Products Guidance, all seven firms were found to already be capturing 'Management Information' on the performance of distribution channels. Uncertainty remained, however, within some of these firms as to what they were supposed to be doing with the data they collected and as to the appropriate standards to assess the information against. The FSA's conclusions in this regard were firstly to impose a requirement to review and consider the nature and complexity of the product being sold. It was suggested that products which required more detailed explanation should not be distributed through non-advised channels. In addition, firms in the UK are expected to carry out due diligence and monitoring exercises with respect to distributors, to help in ensuring that products are reaching their intended target market. Other FSA recommendations include ensuring that firms act on their assessments through methods such as making adjustments to adviser literature, offering training to distributors and in some cases, limiting distribution to specific channels<sup>19</sup>. The UK Structured Products Guidance also provides significant detail in relation to the type of information which issuers should be providing to intermediaries. It remains to be seen how successful this initiative has been and accordingly, the extent to which its requirements might inform IOSCO's final toolkit recommendations.

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<sup>16</sup> This is already the practice for virtually all types of offering documents in jurisdictions such as the U.S.

<sup>17</sup> See footnote 9 above as to FINRA's concerns relating to backtesting.

<sup>18</sup> In the U.S., these suitability determinations are primarily imposed upon distributors, and not issuers.

<sup>19</sup> In the U.S., FINRA has required broker-dealers to ensure that the representatives selling structured products are appropriately trained to do so, and has fined broker-dealers in connection with unsuitable sales where such training did not occur.

## Post-Sales Practices

The IOSCO toolkit outlines a number of possible regulatory measures intended to cover the post-sale period after retail structured products have been distributed. These include:

- *keeping investors informed*—gathering and disseminating key information during the life of a structured product, such as financial performance statistics, details of key events, or past performance (although in many cases, this task would be more appropriately placed in the hands of the intermediary with the ongoing investor relationship under the Suitability Principles);
- *product review*—performance of regular product reviews to gather information that could be used during product design for new products or to take action with respect to an existing product<sup>20</sup>;
- *secondary market making*—where issuers make a secondary market in a particular structured product, they might be required to disclose methods and criteria which explain the relationship between the sale price and the secondary market value of the product<sup>21</sup>;
- *guidance at maturity* – requiring issuers to disclose certain information at the time of a product's maturity, including detailed calculations setting out how the final return was determined;
- *cooling off periods*—a walk-away right provided to retail investors to rescind or cancel a sales contract within a specified post-sale period<sup>22</sup>;
- *complaints procedure*—ensuring that investors have an accessible, available and timely mechanism through which to channel any complaints or concerns they may have after they have purchased the product. Complaints data can also be collected and utilised as part of the product design process for new products;
- *dispute resolution*—providing a formal dispute resolution process for retail structured products may be considered, either privately or through a relevant supervisory authority, provided the process involved participants with minimum levels of independence and expertise in the field<sup>23</sup>; and
- *product intervention powers*—one of the more controversial suggestions in the toolkit is the potential ability of supervisory authorities to either ban outright or suggest changes to product features. This approach has already raised eyebrows in a number of jurisdictions, including the UK, where a policy statement was recently published<sup>24</sup>, providing the FSA with the ability to make product intervention rules, subject to a number of general, contextual and market considerations<sup>25</sup>. Any decisions to make changes on a temporary basis would allow time to consider whether more permanent changes were required. IOSCO considers this to be a last resort measure and is aware of the potential moral hazard risk involved in some products/product features being banned but not others<sup>26</sup>.

## Next Steps

The IOSCO toolkit covers an extremely broad range of possible regulatory tools to direct its members as to what kinds of measures and approaches they might wish to consider in developing their regulatory frameworks for retail structured

<sup>20</sup> NASD Notice 05-26 recommends that U.S. broker-dealers adopt post-approval review practices for complex products.

<sup>21</sup> In the U.S., in the aftermath of the SEC “sweep letter” described above, issuers have started to add additional disclosures about the relationship between the initial offering price of the security, and possible resale prices prior to maturity.

<sup>22</sup> Needless to say, such a requirement would be inconsistent with the current regulatory approach of a variety of jurisdictions, including the U.S., and would introduce substantial uncertainty into the market. For example, if such a right existed, an investor purchasing an index-linked note could presumably seek to exercise this right and avoid losses if the relevant index declined after the purchase date, even if the investor was purchasing a suitable investment.

<sup>23</sup> At present, many jurisdictions have existing resolution procedures in place that apply to structured products in a manner that is comparable to other financial instruments.

<sup>24</sup> PS13/3, FSA: <http://www.fca.org.uk/static/documents/consultation-papers/fsa-ps13-03.pdf>.

<sup>25</sup> See Morrison & Foerster Structured Thoughts, Volume 4, Issue 5, April 12, 2013:

<http://www.mofo.com/files/Uploads/Images/130412-Structured-Thoughts.pdf>.

<sup>26</sup> Regulations of this kind would also be incompatible with the regulatory regime of countries such as the U.S., where regulation is largely achieved through *disclosure*, as opposed to *merit*.

products. In most cases, these suggestions reflect the approaches of regulators in more developed markets such as Europe and the U.S., although many of these are relatively recent. As such, other IOSCO members have the advantage of being able to learn from experiences of the more developed markets and form a view of which elements of the toolkit will be most suitable for their markets. For participants in the more developed structured product markets, however, the Consultation will provide an opportunity to share experiences and feedback advice and conclusions to regulators and other global market participants.

The consultation closes on June 13, 2013.

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Morrison & Foerster named **Structured Products Firm of the Year, Americas, 2012** by *Structured Products* magazine for the fifth time in the last seven years. See the write up at <http://www.mofocom/files/Uploads/Images/120530-Americas-Awards.pdf>.

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