

What to Expect in 2015?

Bradley Berman, Lloyd S. Harmetz, Anna T. Pinedo, Jeremy C. Jennings-Mares and Peter J. Green
Morrison & Foerster LLP

Here are our thoughts on what to expect in the structured products area in 2015.

Dodd-Frank-Related developments

The Volcker Rule: Last year at about this time in December, we were still working our way through the final Volcker Rule. A year has passed and we are still attempting to understand the exceptions that may be available in connection with hedging of exposures arising in connection with the issuance of structured products. We anticipate that there will be additional regulatory guidance on the Volcker Rule. In fact, in their public statements, Federal Reserve representatives have alluded to possible changes relating to the metrics and compliance policy requirements. We anticipate that market participants will continue to work diligently to formulate compliance policies and procedures designed to address the hedging activities in relation to structured products, as well as their market making activities. *Section 621 of the Dodd-Frank Act:* Since the SEC released a proposed rule in 2011 (Rule 127B of the Securities Act) to implement this Dodd-Frank provision, there has been no further activity. The rule would generally prohibit certain persons involved in the structuring, creation and distribution of an asset-backed security 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. As we noted in our last year's recap, depending on the ultimate definition of 'asset-backed security' for these purposes, certain structured products may be covered by the rule's prohibition on conflicts.

Title VII: At this stage, market participants already have adopted approaches to address their hedging activities related to structured products, to the extent that in hedging, 'swaps' are used. We still await final SEC rules relating to security-based swaps.

CPOs: During 2014, the Staff of the CFTC has provided additional relief to various types of vehicles that, in the absence of such guidance, may have been viewed as commodity pools. However, the CFTC exemptive relief does not address trusts used to issue credit-linked or insurance-linked notes, so these transactions merit special attention.

Volcker Covered Funds: Similarly, any trust or similar passive vehicle used to 'repackage' bonds should be closely examined as it may be a 'covered fund' for purposes of the Volcker Rule.

Removing References to Ratings: As we noted in last year's round-up, one of the objectives of the Dodd-Frank Act was to ensure that regulations did not incorporate references to credit ratings as that might cause undue reliance by investors and others on ratings. The SEC has not finalised amendments to Regulation M to eliminate ratings. Depending on the reformulation, this may have an effect on structured products offerings, such as variable price re-offer deals.

Fiduciary Duty: Recent statements made by representatives of the SEC suggest that the imposition of a fiduciary duty is still being considered closely, although the timing is uncertain.

Bank Capital and Related Rules: The principal elements of the Basel III framework were implemented in the United States in July 2013. In 2014, the banking agencies implemented a final liquidity coverage ratio and a final supplemental leverage ratio for the largest banks. In addition, the banking agencies have proposed a capital surcharge for the largest banks. In the meantime, the BCBS has completed its work on the net stable funding ratio framework and the Financial Stability Board has outlined a proposal relating to TLAC, or total loss absorbing capacity. Given that financial institutions are the principal US issuers of structured products, it can be expected that as banks begin to address the cumulative effect of these capital and liquidity measures, their perspective on the types of financial instruments they issue may change. Also, rating agencies likely will continue to refine their ratings assessment of financial institutions based on regulatory changes, and this may affect pricing.

FINRA developments

It has been a relatively quiet year in the sense that FINRA has not issued any investor alerts or regulatory notices related principally to structured products. This should not be viewed as any indication that FINRA has lost its interest in, or focus on,

structured products. As representatives of FINRA have made clear in their public remarks, FINRA continues to watch this segment of the market closely. We anticipate that FINRA will continue to monitor how member firms approach:

Complex Products: FINRA representatives have noted that they are particularly interested in the policies and procedures that firms have implemented relating to vetting new products that may be deemed complex products, as well as conducting post-sale reviews of such products.

KYD: FINRA representatives have addressed the types of diligence inquiries that 'manufacturers' of structured products should undertake in connection with distributors of these products.

Conflicts of Interest Policies and Disclosures: FINRA remains focused on the policies and procedures that member firms implement in order to address conflicts of interest. In the structured products area, FINRA has focused on: conflicts that may arise as a result of the various roles that legal entities within a financial institution may play in the context of a structured product issuance (e.g., issuer, affiliated broker-dealer as underwriter, related party as calculation agent, etc.), conflicts that may arise where brokers are compensated differently in relation to sales of structured products, actual or potential conflicts arising in connection with any proprietary index used as a reference asset, etc.

Reverse Inquiry: Offerings that begin their lives as reverse inquiry transactions and then are more broadly offered and sold seem to be an area that is under scrutiny.

Performance Data or 'Hypothetical Backtested Data': FINRA continues to raise concerns that retail investors place undue reliance on hypothetical backtested data used in marketing materials. Of course, this type of information can be used in issuer-prepared materials filed with the SEC. We anticipate that the discussion on backtested data will continue given that many European regulators expressly require such data to be produced and shared with investors.

Other Developments

Benchmark Indices: European regulators and IOSCO remain focused on the potential issues relating to 'benchmark indices'. Although European legislation regulating benchmark indices has not been adopted yet, both ESMA/EBA and IOSCO have released their principles and global institutions should review their indices in light of these best practices.

Disclosure Reform: the SEC Staff has been undertaking a review of current disclosure requirements. We are hopeful that, as a result of this process and dialogue relating to streamlining disclosure to make it more investor-friendly and accessible, we will have an opportunity in the future to revisit many of the lengthy disclosures that have become a fixture in the structured products market.

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