Morrison & Foerster News Bulletin Volume 6, Issue 9 December 14, 2015

Structured Thoughts

News for the financial services community.

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ESMA Final Report on Complex Debt Instruments and Structured Deposits

On 26 November 2015, the European Securities and Markets Authority ("ESMA") published its Final Report on its "Guidelines on complex debt instruments and structured deposits". The Final Report follows ESMA's Consultation Paper on the same issue published in March 2015 on which we previously reported[1].

Background and Initial Consultation

The Consultation Paper is focused on the "execution-only exemption" contained within the Markets in Financial Instruments Directive ("MiFID") and the amendments to such exemption made pursuant to a recast MiFID Directive now expected to come into force from January 2018 ("MiFID II"). This exemption relates to the level of diligence that firms are required to carry out on their clients before providing financial services to such clients. Where an execution-only service relates to non-complex financial instruments specified in Article 19(6) of the existing MiFID and certain other conditions apply, the investment firm can provide the service to the client without having to carry out either suitability or an appropriateness assessment in relation to such client. The Article 19(6) list of instruments includes bonds and similar debt instruments admitted to trading on a regulated market or equivalent third country market but specifically excludes any such bond or other instrument that embeds a derivative.

[1] See "Difficulty in Understanding? ESMA Consultation Paper on Complex Debt Instruments and Structured Deposits". http://www.mofo.com/~/media/Files/ClientAlert/2015/03/150327ESMAConsultationPaper.pdf

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Article 19(6) of MiFID will be replaced by Article 25(4) of MiFID II when it comes into force. In addition to the exclusion of debt and other instruments embedding derivatives, the exemption will also exclude (i) bonds or other securitised debt incorporating a structure which makes it difficult for the client to understand the risk involved and (ii) structured deposits which incorporate a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before its term. ESMA is required under MiFID II to develop technical standards by 3 January 2016 as to how these additional provisions should be assessed.

Final Report

In its Final Report, ESMA notes that it received 32 responses to the Consultation Paper. Following this feedback, ESMA states that it has made some modifications to the Guidelines set out in the Consultation Paper and provided further analysis in relation to what it regards as an embedded derivative.

A key element of ESMA's previous Consultation Paper was its non-exhaustive list of debt instruments which it would generally regard as embedding a derivative or incorporating a structure, making it difficult for the client to understand the risk involved and, in each case, therefore not being capable of falling within the execution-only exemption. In the Final Report, these examples have now been moved into a table within the Guidelines themselves.

Instruments Embedding a Derivative

In relation to the examples of instruments that ESMA regards as embedding a derivative, the only change to the previous Consultation Paper is the deletion of inflation-indexed bonds. Following the responses to the Consultation Paper, ESMA acknowledges that such bonds are widely used by retail investors as a hedge against inflation, and the average retail investor normally understands the mechanism involved. ESMA states that it accepts the argument that the link between the coupon or principal payment and the inflation rate should not be regarded as an embedded derivative within the meaning of the guidelines, and such products should not, therefore, be regarded as complex. Convertible/exchangeable bonds, indexed bonds and turbo certificates, contingent convertible bonds, callable/puttable bonds, credit-linked notes and warrants all remain within the list of examples of debt instruments embedding a derivative.

Instruments Incorporating a Structure Making it Difficult for the Client to Understand the Risk

In relation to instruments that incorporate a structure making it difficult for the client to understand the risk, ESMA has deleted the general definition contained in the Consultation Paper stating that this should be interpreted as meaning "a structure and the related risks that an average retail client would be unlikely to readily understand" following feedback in the consultation that this general reference was not helpful in practice. In its list of examples of products that would normally be regarded as coming within this category, very few changes have been made by ESMA, but the following points should be noted:

- The examples now include a specific reference to debt instruments with complex mechanisms to determine or calculate the return. It is stated that this category includes debt instruments structured in such a way that the anticipated revenue stream may vary frequently and/or markedly at different points of time over the duration of the instrument either because certain pre-determined threshold conditions are met or because certain time points are reached.
- ESMA has accepted that the fact a debt instrument is denominated in a non-domestic currency should not automatically make the instrument complex and should not, therefore, be regarded as coming within its categorisation of debt instruments with an unfamiliar or unusual underlying.
- ESMA has deleted the specific reference to instruments that would be regarded as packaged products under the PRIIPs Regulation on the basis that such products will almost certainly be deemed complex under one of the other categorisations.
- In relation to debt instruments issued by SPVs, a slight change has been made to state that this applies in circumstances in which the name of the debt instrument or legal name of the SPV may mislead investors as to the identity of the issuer or guarantor.

In relation to the list of criteria that would result in a structured deposit incorporating a structure making it difficult for the client to understand the risk of return, ESMA has added the situation where the contract gives the credit institution the unilateral right to terminate the agreement before maturity.

Examples of Non-Complex Products

In addition to examples of debt instruments that would generally be regarded as complex, the Consultation Paper also included a list of debt instruments that would be generally regarded as non-complex by reference to the relevant criteria, although this was a short list comprising of step-up notes (providing for an increasing rate of interest over time according to a predefined schedule), floating rate notes and covered bonds. The Final Report includes an additional list of instruments that it would not regard as embedding a derivative or incorporating a structure which makes it difficult to understand the risk, including:

- inflation-linked notes;
- debt instruments denominated in a currency different from the one of the jurisdiction where the investment services are provided; and
- structured deposits where the return is linked to a currency which is not the one of the jurisdiction where the structured deposit is offered.

ESMA also states that it accepts the argument that a tax clause feature (allowing the issuer to redeem an instrument in the case of future changes to tax law that would require it to make additional payments) is relatively simple and should not make an instrument complex for the purpose of the Guidelines.

Next Steps

ESMA now regards the Guidelines as final and states that they will now be translated into the official EU languages and published on ESMA's website. The publication of the translations will trigger a two-month period during which national competent authorities must notify ESMA whether they comply or intend to comply with the Guidelines.

PRIIPs – Latest Consultation Paper from the ESAs

On November 11, 2015, a Joint Consultation Paper[2] in relation to PRIIPs Key Information Documents was published by the European Banking Authority ("EBA"), the European Securities and Markets Authority ("ESMA") and the European Insurance and Occupational Pensions Authority ("EIOPA", and together, the "ESAs"). The paper sets out draft regulatory technical standards ("RTS") with regard to presentation, review and provision of the Key Information Document ("KID") required to be provided in respect of packaged retail investment and insurance-based products ("PRIIPs") pursuant to the EU Regulation in relation to PRIIPS (the "PRIIPS Regulation)[3], which came into force on 29 December 2014. The Consultation Paper includes proposals in relation to the methodologies underpinning the presentation of the risk reward profile and costs information required to be contained in the KID. The obligation on product manufacturers to prepare a KID will commence from the beginning of 2017.

The Consultation follows a joint discussion paper published by the ESAs in relation to the presentation and content of the KID published in November 2014 and a technical discussion paper on the same issues published by the ESAs on 23 June 2015[4].

Proposals in Relation to the Presentation and Content of the KID

The draft RTS provides a mandatory template to be used for each KID (including mandatory text). Certain permitted adaptations to the template are also provided. Amongst the major issues dealt with in relation to presentation and content are:

[2] http://www.esma.europa.eu/system/files/jc_2015_073_cp_priips_key_information_documentsb.pdf

[3] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_352_R_0001&from=EN

[4] http://www.mofo.com/~/media/Files/Newsletter/2015/08/150831StructuredThoughts.pdf

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Risk indicators:

The draft RTS requires a summary risk indicator ranking the PRIIP on a numerical scale from 1 (lowest risk class) to 7 (highest risk class). The draft RTS contain a methodology for the assignment to each PRIIP of the relevant risk class, the inclusion of narrative explanations and, for certain PRIIPs, additional warnings.

The criteria for establishing the relevant risk class is set out in Annex II to the draft RTS. The criteria primarily comprise credit risk and market risk. In addition, for products that can be traded over the life of the product but for which no regulated liquid market exists, a warning shall be included under the risk indicator that selling the PRIIP before the recommended holding period may not be possible and may give rise to significant costs or losses. Where a product is denominated in a currency other than the legal tender in the member state in which it is being marketed, a narrative must be included stating that the return the investor gets may be higher or lower as a result of currency fluctuations.

Performance scenarios:

The draft RTS set out requirements for performance scenarios which are to be defined for the recommended holding period and for certain holding periods in between. The KID is required to include three performance scenarios: an unfavourable scenario, a moderate scenario and a favourable scenario. Annex IV to the RTS sets out the criteria to be used in relation to each scenario. Annex V sets out how the performance scenarios are to be presented, which also includes a template for the narrative to go under the performance scenarios. For insurance-based products, an additional performance scenario must be included reflecting the return the retail investor receives if a covered insurance event occurs.

Costs:

The draft RTS set out various requirements in relation to the presentation of costs. These require the inclusion of two tables – one entitled “Costs over time” and the other entitled “Composition of costs”. The format of these tables is set out in Annex VII to the RTS.

In the “Costs over time” table, a single figure must be shown as the summary cost indicator of the total aggregated costs of the PRIIP. The methodology for the calculation is set out in Annex VI to the RTS. The figure is required to be expressed in both monetary and percentage terms. If relevant, a narrative must also be included stating that the table takes into account exit penalties. The table must also include a breakdown of one-off costs, recurring costs and incidental costs, all in accordance with methodology specified in Annex VI to the RTS. It must also include an aggregated figure of total costs and a percentage reduction in yield (“RIY”) figure showing the impact of total costs on investor returns.

The “Composition of costs” table must include a narrative explanation of each of the costs specified and must state that the costs presented in the KID may differ from the actual costs the retail investor would pay, including where additional costs may arise where the investor chooses options throughout the life of the investment.

Revision of the KID

The draft RTS set out requirements for revision of the KID by the PRIIP manufacturer. The KID must be reviewed at least every 12 months. As part of the review, the PRIIP manufacturer must verify whether the information contained in the KID continues to be accurate, fair, clear and not misleading, and remains consistent with the content requirements of the KID under the PRIIPs regulation. The PRIIP manufacturer must also conduct an ad hoc review of the KID if it becomes aware of any change that affects or is likely to affect the information contained in the KID. In each case, the PRIIP manufacturer must revise the KID, as appropriate, following such review and that revision must include all information in the KID that needs to be updated so that the KID is up-to-date as a whole.

Timing of Publication of the KID

The draft RTS state that the person advising on or selling the PRIIP will be considered to have provided the KID in “good time” (as required by the PRIIPs Regulation) where they have provided the document sufficiently early for the retail investor to read and consider the document before being bound by any contract or offer relating to the PRIIP. In determining how long the investor needs in this regard, the person advising or selling the PRIIP must take into account, as appropriate: (a) the knowledge and experience of the retail investor with the PRIIP (or a similar PRIIP), (b) the complexity of the PRIIP and (c) the urgency for the retail investor of concluding the proposed contract or offer.

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Consultation Questions

The Consultation Paper also sets out various questions where the ESAs seek specific feedback from stakeholders. These include whether the ESAs should clarify further the criteria for the comprehension alert required under the PRIIPs Regulation, whether PRIIPs manufacturers can voluntarily increase the specified risk indicator (this is not currently permitted under the draft RTS), whether the look-through approach in relation to the assessment of credit risk for a PRIIP packaged into another PRIIP is appropriate and whether the presentation of performance scenarios would be better in a graph than a table (or should be presented in both a graph and a table). There are also questions relating to the methodology used for the calculation of transaction costs.

Next Steps

The Consultation is open for response until 29 January 2016. The ESAs state that the final RTS, including feedback on the Consultation Paper, will be submitted to the EU Commission for endorsement by 31 March 2016. PRIIPs manufacturers must prepare and publish a KID for each PRIIP they manufacture for sale to retail investors from 1 January 2017, and, from such date, those selling or advising on PRIIPs must provide a KID to retail investors.

Euribor Is Moving to a Transaction-Based Rate

At a SIFMA Roundtable on December 2, 2015, representatives of the European Money Market Institute ("EMMI") explained their plan to change the Euribor rate from the current quotation-based system to a rate based on actual transactions. The new rate will be called Euribor+. According to EMMI, one of the goals is to achieve a "seamless transition" in which no current EURIBOR-based contracts would be disrupted. At the end of the transition, Euribor+ will continue to be published on the same data vendor pages, such as Reuters page EURIBOR01. EMMI administers the Euribor and Eonia rates.

Currently, Euribor is defined as "the rate at which euro interbank term deposits are being offered within the EU and EFTA countries by one Prime Bank to another at 11:00 a.m. Brussels time." The definition of Euribor+ would be "the rate at which banks of sound financial standing could borrow funds in the EU and EFTA countries in the wholesale, unsecured money markets in euro."

The key difference between current Euribor and Euribor+ is that Euribor relies on quotes and member bank estimates of prime bank activity, while Euribor+ will rely on actual wholesale borrowing transactions executed by the member bank. Euribor's current estimate of bank funding rates as a point-in-time average will be replaced by the Euribor+ backward-looking period average.

One result of the planned changeover will be that ISDA will have to amend Section 7.1(f)(iv) ("EUR-EURIBOR-Reference Banks") of the 2006 ISDA Definitions. This provision refers to rates quoted by major banks in the Euro-zone at approximately 11:00 a.m., Brussels time, for offered deposits in euros by four banks in the Euro-zone, and loans in euros to leading European banks. These fallback provisions would also have to be changed to transaction-based quotes, mirroring Euribor+. Documents for securities offerings, such as medium-term note programs, will also be modified to reflect these developments.

The transition to Euribor+ is targeted to take effect on July 4, 2016. Bring on the fireworks!

SEC Approves Amendments to FINRA Rule 2210 to Require a BrokerCheck Link on Members' Retail Websites

New amendments to FINRA Rule 2210 that will require member firms' retail websites to include a readily apparent reference and hyperlink to BrokerCheck have been approved by the SEC. The hyperlink will be required on each firm's initial web page intended to be viewed by retail investors and also on any other web page that includes a professional

profile of one or more registered persons who conduct business with retail investors. The amendments will become effective on June 6, 2016.

In Regulatory Notice 15-50, issued on December 7, 2015, FINRA commented on a number of aspects of the amendments. For example, FINRA clarified that Rule 2210, as amended, will not require a member firm to add the BrokerCheck hyperlink to communications appearing on a third-party website. Consequently, communications appearing on Twitter or LinkedIn will not need to include the BrokerCheck hyperlink. Similarly, the hyperlink will not be required to be added to each e-mail or text message sent by a member firm or a registered person to a retail investor. FINRA also added some clarity to what constitutes a "readily apparent" hyperlink, discussing frequently recurring questions such as placement, font size and font color.

FINRA members that maintain websites for their structured notes will need to consider the application of these new rules, and whether it will be appropriate to add links.

The SEC's ETN Investor Bulletin

On December 1, 2015, the SEC's Office of Investor Education and Advocacy issued an investor bulletin to educate investors about exchange-traded notes (ETNs).[5] In particular, the bulletin explains how ETNs differ from exchange-traded funds (ETFs) and certain risk factors that are associated with an investment in ETNs.

The investor bulletin highlighted some of the differences between ETNs and ETFs, noting that there is some investor confusion in distinguishing the two:

- ETFs are registered investment companies. As such, an investor in an ETF has ownership interest in an underlying portfolio of assets.
- Unlike ETFs, ETNs do not own an underlying portfolio of assets, which makes holders of ETNs subject to the creditworthiness of the issuer itself.
- ETFs issue and redeem their shares in creation units at their net asset value.
- Rather than using net asset value, ETN issuers calculate the value of the ETN using a described formula.

The investor bulletin provides a list of potential risks to consider before investing in ETNs. Those risks include:

- The complexity of ETNs and their fees, which are included in either the reference asset or the calculation of the value of the ETN.
- Credit risk – Investors in ETNs are subject to the creditworthiness of the issuer and would be creditors if the issuer defaults on payments.
- Leveraged, inverse, or inverse-leveraged ETNs reset their exposure to the exposure level stated in the prospectus on a daily basis, which means that all investors receive an equal amount of leveraged, inverse, or inverse-leveraged exposure.
- Investors holding such ETNs for more than one day should not expect to receive returns proportional to the exposure stated in the prospectus, and the difference could be significant.
- Leveraged, inverse, or inverse-leveraged ETNs should not be used as buy-and-hold investments.

This investor bulletin is one of several regulatory pronouncements regarding ETNs over the last several years. The investor bulletin is quite similar to the Financial Industry Regulatory Authority, Inc.'s Investor Alert "Exchange Traded Notes—Avoid Unpleasant Surprises," issued in July 2012.[6] The SEC's Division of Corporation Finance sent a sweep letter

[5] The investor bulletin can be found at: http://www.sec.gov/oiea/investor-alerts-bulletins/ib_etn.html.
[6] See our article in Structured Thoughts, Vol. 3, Issue 10 (July 20, 2012), which may be found at: http://media.mofo.com/files/Uploads/Images/120720-Structured-Thoughts.pdf

to several ETN issuers in February 2014, and the Division of Market Regulation published a request for comment on exchange-traded products, including ETNs, in June 2015.[7]

EU Regulatory Agenda: Into 2016

Derivatives Reporting

The European Market Infrastructure Regulation ("EMIR"), providing for the regulation of derivatives in the EU, has been in force since 2012, and rules requiring reporting of derivative transactions to trade repositories started to be phased in from early 2014. In April 2015, the European Securities and Markets Authority ("ESMA") announced its plans for a single access point for trade repository data under EMIR. The facility will be called the Trade Repositories Project and will provide ESMA and national competent authorities with immediate access to 300 million weekly reports on derivatives contracts received from 5,000 different counterparties across the EU trade repositories, all through a single platform. It is assumed that data submitted will not be accessible to market participants other than ESMA and the 27 national competent authorities, although questions remain around what the regulators will do with the data once received. The project is expected to go live in 2016, with the aim of bringing transparency and clarity to the EMIR trade reporting mandate. Furthermore, in November 2015, ESMA published an update of the existing technical standards on EMIR reporting. The updated technical standards aim to address the shortcomings and limitations in EMIR reporting that have come to light since its implementation by instituting a more consistent and harmonised approach to population of data fields and reporting of complex derivatives. The final draft technical standards have been sent to the Commission, which has three months within which to endorse them, and then, if approved by the European Parliament and the Council of the EU, these may take effect in 2016.

Derivatives Clearing

From June 2016, mandatory central clearing for OTC interest rate swaps denominated in euros, pounds sterling, Japanese yen and US dollars will apply, following publication of the final draft regulatory standards ("RTS") relating to these currencies in the Official Journal of the EU (the "OJ") on 1 December 2015. The classes of derivatives covered by this obligation will be plain vanilla interest rate basis swap derivatives, fixed-to-float swaps, forward rate agreements and overnight index swaps. The clearing obligations will be applied to four different categories of counterparties, each with different phase-in periods in order to give smaller market participants additional time to begin complying. The clearing obligation for Category 1 counterparties (clearing members) will take effect on 21 June 2016 and for Category 2 counterparties (other financial counterparties or alternative investment funds (AIFs) with outstanding trades with a gross notional amount exceeding EUR8bn) on 21 December 2016. The obligations for Category 3 (other financial counterparties or AIFs) and Category 4 (all other non-financial counterparties) counterparties will take effect in 2017 and 2018 respectively. In addition to this, in November 2015, ESMA published a final report setting out additional draft regulatory technical standards which propose mandatory clearing for interest rate derivatives denominated in Norwegian krone, Polish zloty and Swedish krona. This draft has been sent to the Commission, who have three months within which to endorse it, after which there will be a period of scrutiny by the European Parliament and the Council of the EU before it can then be published in the OJ. We may, therefore, see mandatory clearing introduced for these currencies in 2016.

Derivatives Margining

In respect of any OTC derivatives transactions which are not subject to central clearing, EMIR requires certain counterparties to exchange collateral as a way of reducing counterparty risk exposure. In its June 2015 consultation paper, the European Supervisory Authorities' draft RTS prescribed the amount of initial and variation margin to be posted and collected as collateral and provided for the phase-in of these margin requirements by applying the initial margin requirements only to the largest counterparties from the outset in September 2016, with a deadline of September 2020 for all counterparties with a notional amount of non-centrally cleared derivatives in excess of EUR 8 billion. Variation margin

[7] We discussed the ETN sweep letter in Structured Thoughts, Vol. 5, Issue 3 (Apr. 9, 2014), which may be found at: http://www.mofo.com/~/media/140409StructuredThoughts.pdf, and we discussed the ETP Request for Comment in Structured Thoughts, Vol. 6, Issue 4 (June 23, 2015), which may be found at: http://www.mofo.com/~/media/Files/Newsletter/2015/06/150623StructuredThoughts.pdf.

requirements for the largest institutions, i.e., those with an aggregate average notional amount of non-centrally cleared derivatives above EUR 3 trillion, is expected to apply from 1 September 2016 and to all other counterparties from 1 March 2017. The draft RTS are expected to be finalised in January 2016.

PRIIPs

The regulation on key information documents ("KIDs") for packaged retail and insurance-based investment products ("PRIIPs") will become effective in December 2016. When a person is advising on or selling a PRIIP to retail investors, a pre-contract KID must be provided to the investor. The regulation contains detailed requirements as to the form and content of the KID. In November 2015, the ESAs released a joint consultation paper setting out draft regulatory technical standards focusing on the presentation and content of the KID (including methodologies for calculating and presenting risks, rewards and costs), the review, revision and republication of KIDs, and the conditions for fulfilling the requirement to provide the KID in good time. Input in respect of the consultation is invited by the end of January 2016.

Benchmark Regulation

The use of benchmarks in financial transactions has been in focus in recent years following alleged misconduct in relation to the setting of LIBOR and other financial indebtedness. In July 2013, the International Organisation of Securities Commissions ("IOSCO") published principles for financial benchmarks, and later that year the European Commission published a draft regulation in relation to indices used as benchmarks in financial contracts, with the aim of reducing the risk of manipulation by ensuring that benchmark providers in the EU have prior authorisation and are subject to prior supervision. On 24 November 2015, the Council of the EU, the European Parliament and the Commission reached a preliminary political agreement on the proposed benchmark regulation. It includes a classification of benchmarks based on three categories with obligations (governance, transparency of methodologies and administrators' obligations) applied proportionately to these categories, as well as an equivalence regime for the purpose of recognition of non-European benchmarks within the EU. Subject to endorsement by the Council of the EU and the European Parliament by the end of 2015, the final, agreed text of the regulation will be adopted and subjected to legal review. Publication in the OJ is expected in March or April 2016, although the regulation will not apply for a further 12 months thereafter.

Prospectus Directive (PD3)

As part of its Capital Markets Union action plan, on 30 November 2015, the European Commission proposed a number of adjustments to the rules governing fundraising on public markets or through offers to the public, in the form of a regulation that will replace the current Prospectus Directive. In particular, focus has fallen on the somewhat burdensome requirements of mandatory disclosure under the Prospectus Directive (such amendments forming the basis of a second significant overhaul of the legislation, therefore coining the term "PD3"). Proposed amendments are varied but concentrate on reducing requirements for small-and medium-sized companies. They include (amongst others) broader exemptions for small capital raisings (it is currently proposed that no prospectus will be required for capital raisings which are, in total, below €500,000 (up from €100,000 at present)), creation of a lighter-touch disclosure regime for SMEs, reduction in the length of prospectus summaries (and welcome harmonisation of such summaries with the KID required under the PRIIPs Regulation), fast-tracking and simplification for frequent issuers via use of a "Universal Registration Document" (similar to a shelf registration concept) and creation of a single access point for all EU prospectuses, making them more available and accessible for investors. Most of the other exemptions from publishing a prospectus for an offer of securities to the public in the EU remain unchanged, such as the professional investor exemption, the 150 offerees per EU-member state exemption and offers addressed to investors who acquire securities for a total consideration of at least €100,000 per investor (though the minimum denomination exemption of €100,000 is proposed to be removed). It is not yet known when the new regulation is proposed to take effect.

MiFID II

MiFID II is the overhaul of the Markets in Financial Instruments Directive and comprises a Regulation ("MiFIR") and a recast Directive. It came into force in August 2014 but was not slated to become effective until 1 January 2017. Following confirmation by ESMA in October that MiFID's technical standards (including provisions relating to investor protection, market infrastructure, compulsory exchange trading of derivatives and pre-and post-trade transparency for derivatives and debt securities) would not be finalised until March 2016 at the earliest, the European Parliament (on 27 November 2015) confirmed that it was ready to accept a one year delay of the package of proposals, subject to the swift finalisation of the implementing legislation and a clear roadmap for setting up implementation work. In the meantime, 2016 will see work

continue in relation to finalising the secondary legislation, consulting on a range of outstanding issues, including systems and controls, enforcement and client assets, as well as transposition (in respect of the Directive) into the domestic laws of Member States.

U.S. Regulatory Developments: What to Expect in 2016

As we make our annual prognostications, there is less visibility than in years past regarding many regulatory and enforcement matters. The majority of the regulations required by the Dodd-Frank Act have been adopted, and the Basel III framework has come together. Below, we offer some thoughts.

The SEC and Fiduciary Duties

Fiduciary duty—perhaps one of the most anticipated issues remains for the SEC to propose a heightened standard for broker-dealers akin to a fiduciary duty. The SEC was required by the Dodd-Frank Act to undertake a study regarding an enhanced duty for broker-dealers. Following completion of this study, the SEC requested quantitative information regarding the effect of the imposition of a heightened duty. More recently, Chair White has noted that addressing rulemaking in this area is a high priority.

Department of Labor Fiduciary Regulations

Market participants remain concerned that the Department of Labor ("DOL") proposed fiduciary regulations will move forward. The most likely impacted lines of business under the proposed DOL regulations will be IRAs, and plans that have (i) fewer than 100 participants and (ii) investment managers with less than $100 million in assets under management. For those entities, the broker-dealer will most likely need to comply with the "Best Interest Contract Exemption" ("BICE"), which will require, among other things, that the broker contractually (i) acknowledge that it is a fiduciary, (ii) that it will comply with the ERISA prudence standards and otherwise act in the best interest of the plan, and will consider the investment objectives, risk tolerance and financial circumstances of the plan, (iii) that it will disclose conflicts of interest, (iv) that compensation to the broker is reasonable, (v) that it will comply with federal and state laws regarding the rendering of investment advice, etc. (entities never previously had to worry about state laws under ERISA), (vi) that it will disclose to DOL that this exemption is being used, and (vii) that the contract not have any provision exculpating the broker dealer or requiring disputes to be submitted to arbitration or limiting the availability of class actions. For non-IRAs or plans having 100 or more participants or investment advisers who manage $100 million or more in assets, brokers acting as fiduciaries under the DOL's expanded definition will most likely need to meet a subset of the BICE rules called the "impartial conduct" requirements, which are basically subsumed by (ii), (iii), and (iv) above.

Both the DOL standard (and likely the SEC standard) will affect brokers that sell proprietary products and illiquid-products. Similarly, the standard will have a greater impact on transactions in which the broker-dealer acts as a principal, compared to transactions in which the broker-dealer acts as an agent.

Accredited Investor Definition

The SEC was required by the Dodd-Frank Act to conduct regular review of the appropriateness of the definition. SEC representatives have said that the study is nearing completion.

Federal Reserve Rules for G-SIBs

Final Federal Reserve Board's ("Fed") rules for G-SIBs relating to long-term debt ("LTD"), total loss absorbing capacity ("TLAC") and the maintenance of a clean holding company —the comment period relating to the proposed rules closes in February 2016. As we have previously reported, we anticipate that the final rules will be released mid-year 2016. U.S. G-SIBs and foreign G-SIBs subject to a U.S. intermediate holding company requirement are assessing the impact of the proposed rules and studying whether future issuances of structured products will be below the specified permissible capped amount or require the creation of a finance subsidiary.

Financial Stability Board's ("FSB") Final TLAC Principles

As previously reported, the FSB Principles also affect structured note issuances for non-U.S. G-SIBs. Although each national regulator will need to formulate regulations to implement the FSB Principles for their G-SIBs, we anticipate that this process will be completed in 2016. We anticipate that other jurisdictions, such as, for example, Canada, will adopt regulations that are similar to the FSB Principles for their own domestic systemically important banks (D-SIBs).

Overall Impact on Structured Notes Market

As we have previously discussed, European banks (G-SIBs and non-G-SIBs) will be subject to a bail-in regime and structured notes are subject to bail in. The effect of bail-in, the Fed's LTD, TLAC, and clean holding company requirement, and the FSB Principles on the debt markets and especially on the structured products market will be significant. We anticipate that 2016 will be marked by disruption and transition.

Intermediate Holding Companies

Certain foreign banks doing business in the United States, including some frequent structured notes issuers, are required to comply by 2017 with an intermediate holding company requirement. Formation of the IHC, and capitalizing and funding the IHC, will require significant resources.

Regulation of the Use Derivatives by Funds

As discussed elsewhere in this issue, the SEC recently proposed regulations that would limit the use of derivatives by certain funds, including certain ETFs. These regulations may indirectly affect products that reference ETFs.

Conflicts Rule

Section 621 of the Dodd Frank Act requires that the SEC implement final rules prohibiting a broker-dealer from entering into certain hedging arrangements in connection with asset-backed securities transactions, which arrangements would result in a conflict of interest between the broker-dealer and investors in the ABS transactions. Final rules have not been adopted. Depending upon the definition of "asset-backed security," certain credit-linked notes may be impacted.

Securities-based Swaps Regulations

The regulations related to securities-based swaps will not become effective until at least 2017. However, market participants will need to begin their compliance planning in 2016. The SEC has not released final rules relating to certain securities-based swaps matters.

Margin

Swap market participants other than commercial end users will devote significant resources next year to compliance with the prudential regulators' and CFTC's rules requiring margin for uncleared swaps. Those rules, which are scheduled to be phased into effect starting in September of next year, upend longstanding practices in the swaps market by, among other things, requiring many market participants to post initial margin, similar to typical practice in the futures market. ISDA has started the process of determining the extent to which it may be able to facilitate compliance by means of one or more margin-related protocols.

Debt Research Rules

In February 2016, FINRA's final rules relating to debt research will become effective. To the extent that market participants produce research on certain debt indices that may be reference assets, compliance with the debt research rules will be required.

SEC ETP Review

Commenters responded to a request from the Division of Trading & Markets earlier this year for information regarding

exchange-traded products, including ETNs. The commenters focused principally on ETFs. It will be interesting to see whether the request and comments results in any policy or rule changes.

FINRA Rules
FINRA representatives have commented that amendments to the communication rules will be released in 2016. We also expect that FINRA will continue to focus on the adequacy of member firm policies addressing potential and mitigating actual conflicts of interest.

Complimentary Webinar: TLAC, the Long-Term Debt Requirement, and the Clean Holding Company Proposal

IFLR Webinar

As 2015 draws to a close, regulators have issued a number of new requirements aimed at systemically important lenders. These include the FSB's final TLAC principles for G-SIBs and the US Federal Reserve Board's notice of proposed rulemaking regarding a long-term debt requirement, a TLAC requirement and a clean holding company requirement for US G-SIBs, and the intermediate holding companies of foreign (non-US) G-SIBs subject to an IHC requirement. Although consistent in their objectives, these all differ in certain important respects. The requirements will have broad impacts on the ways in which G-SIBs finance their operations. Given that banks are frequent debt issuers, the effects of these changes will impact the debt capital markets.

The webinar will take place on **December 17, 2015**, from 11:00 a.m. – 12:30 p.m. EST.

Topics Will Include:

- The FSB's final TLAC principles;
- The FRB's proposed requirements;
- The principal differences between the FSB's and the FRB's approach;
- The planning required of G-SIBs in order to prepare to comply;
- Potential effects for foreign banks subject to both regimes; and
- Anticipated effect on how banks will fund going forward.

Speakers:

- Todd Mahoney, UBS
- Ahmet Yetis, UBS
- Oliver I. Ireland, Morrison & Foerster
- Anna T. Pinedo, Morrison & Foerster

For more information or to register, visit http://www.mofo.com/resources/events/2015/12/151217tlaciflr

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Morrison & Foerster has been shortlisted for Law Firm of the Year for *EQDerivatives*' Global Equity & Volatility Derivatives Awards 2016.

Morrison & Foerster was named Best Law Firm for Derivatives – US, 2015 by GlobalCapital at its US Derivatives Awards.

Morrison & Foerster has been named Structured Products Firm of the Year, Americas by *Structured Products* magazine six times in the last ten years. Morrison & Foerster was named Best Law Firm in the Americas, 2012, 2013, 2014 and 2015 by *Structured Retail Products.com*.

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