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Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Updating Unregistered Structured Note Programs: How Frequently? 1
SEC Challenges Use of Survivor Options…… 2
TLAC: Clearing up Misconceptions................. 3
Credit-Linked Notes: Germany and the United States 6
Recent Canadian Tax Proposals Further Amend the Tax Treatment of Linked Notes..... 6
FINRA TRACE Reporting and Time of Execution 7
FINRA Re-Proposes Enhanced Pricing Disclosure on Customer Confirmations in Connection with Fixed Income Transactions... 8
SEC Rule 206(3)-3T to Sunset on December 31, 2016 9

Updating Unregistered Structured Note Programs: How Frequently?

For some types of securities offering programs, we have “black letter law” that instructs issuers how frequently the program documentation should be updated and their offering documents refreshed. For example, U.S. shelf registration statements must be renewed every three years. Prospectuses for EMTN programs that are required under the European Union’s “prospectus directive” must be updated annually.

However, what guidance do we have for exempt bank note programs? Structured CD programs? Rule 144A or Regulation D structured note programs? We are often asked about the timing for proposed updates for these programs, as they are not subject to a specific set of updating rules. As a result, in this article, we discuss the considerations that may inform a decision about when it is time to refresh one of these programs.

Adequacy of Disclosures About the Issuer. The first order of business in addressing this question is to understand whether the issuer-related disclosures included in the current program offering materials are up-to-date. A typical exempt offering program will “forward-incorporate” issuer disclosures from the relevant issuer’s Exchange Act filings (or similar documents in the issuer’s home jurisdiction), including the relevant risk factors relating to the issuer’s business and financial results. However, even if this is the case, the disclosures in the relevant offering documents should be evaluated to ensure that these are current. Have significant mergers, acquisitions, or dispositions occurred since the last time the issuer’s business was described? Has there been some other fundamental change in the issuer’s business? Are any summary or long-form financial statements that are provided in the program documents too stale to be meaningful?

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Even the summary business description that may appear in an offering circular could be outdated. If so, a refresh of the program may be advisable.

Investor Base. Institutional investors, such as those that purchase securities in a Rule 144A program, may be deemed to have access to, and be more likely to understand, the issuer's recent financial results. Accordingly, if the issuer's most recent reports are incorporated by reference, it may be deemed less useful to refresh a program. However, at the other end of the spectrum, for example, in the case of bank notes or CDs that may be offered to retail investors, it may be useful to include recent summary financial information and to reference specifically the most recent company reports that an investor may look to for key business and financial information.

Currency of Risk Factors and Technical Terms. Many frequent issuers of structured notes have multiple registered and unregistered issuance platforms. Over time, as these programs are updated, the issuers will revise (and modernize?) their risk factors, as well as more technical disclosures such as redemption procedures, "market disruption events," anti-dilution provisions for common equity securities, events of default, the authority of the calculation agent, and other matters. To the extent these items have been updated in other programs, an issuer may deem it advisable, and administratively more convenient, to ensure that its unregistered programs are similarly revised to match up the relevant provisions.

Underlying Program Documents. Most of our discussion so far has focused on the disclosure documents that are used in connection with a program. However, there are a variety of other documents that should be considered in connection with a program:

- Indenture/Paying Agency Agreement: are the covenants, events of default, and other provisions consistent with the issuer's other program documents, current market practice, and current regulatory requirements?[1]
- Program Agreement: does the agreement between the issuer and the distributors set forth appropriate representations, warranties, and covenants? Do these provisions conform to current practices and to the distributors' due diligence requirements?
- Legal Opinions and Comfort Letter: is the existing suite of "deliverables" sufficient in light of current regulatory and risk management needs? Are there any current business and legal issues facing the issuer?

Marketing Considerations. Last, but not least, optics may matter. In some exempt offering programs, it may be reasonable to rely on a base offering document that is three or more years old. In other contexts, particularly when retail investors are involved, an "old" offering document may seem out of place, even if it includes and/or incorporates information that is fairly current. In each case, the views of the relevant distributors should be considered carefully.

Conclusion

We would not suggest that there is a single right answer regarding the frequency of program updates. However, upon consideration of the issues discussed above, the issuer, the distributors, and their respective counsel can make a judgment.

SEC Challenges Use of Survivor Options

New SEC Proceeding

In August 2016, the SEC filed cease and desist proceedings against a U.S. private fund and its manager. The action alleges that the manager solicited terminally ill patients to open brokerage accounts that would hold instruments with survivor options, and, upon their deaths, the private fund received significant funds upon early redemptions.

The SEC's complaint can be found at the following link: https://www.sec.gov/litigation/admin/2016/33-10120.pdf.

[1] As readers of this publication know, regulatory requirements, such as the liquidity coverage ratio, or LCR, and requirements such as those proposed by the U.S. Federal Reserve Board to maintain certain long-term debt that meets the eligibility requirements for total loss absorbing capacity, or TLAC, may influence certain issuance programs.

The suit alleges that the fund recruited terminally ill patients at nursing homes and hospices. The fund paid cash to these individuals to use their names on joint brokerage accounts with the fund manager. These accounts would hold investments that had survivor option features, and, upon the death of the terminally ill patient, the redemption proceeds would be paid to the investment fund. The proceeding challenges these practices on two principal grounds:

- falsely claiming that the deceased individuals jointly owned the instruments, when the private fund was the true owner; and
- violating the SEC's custody rules under the Investment Advisers Act by placing the fund's investment assets in the names of the fund manager and the deceased individuals.

The Fund's Investment Strategy

The fund's investment strategy was unusual: purchasing discounted instruments that had a survivor option feature, and then exercising the right when the terminally ill patient passed away. The investment plan was described in the fund's private placement memorandum.[2]

How were the terminally ill patients solicited? The fund manager allegedly created a new company, and used contacts at nursing homes and hospices to identify terminally ill patients.[3] These patients were offered a cash payment to use their names on joint accounts, which were opened on behalf of the fund manager, on the one hand, and the patient, on the other hand. The fund manager then purchased instruments with survivor options in the secondary market at a price that was well under par and placed them in the relevant accounts, where they were held until the death of the patient.

Responses by Issuers

In a prior issue of this publication,[4] we discussed the use of survivor options in structured notes and structured CDs and the possibility for abuse. In response to these potential abuses, some issuers have implemented terms in their survivor options that have a longer required holding period before exercise, or that can only be exercised by the initial purchaser of the instrument. In addition, some issuers have been more active in attempting to identify vulture-type schemes of this type, by looking for holders who are filing repeat claims for survivor option redemptions.

TLAC: Clearing up Misconceptions

The popular press is perpetuating misconceptions regarding the Federal Reserve's proposed TLAC requirements. The TLAC proposal is leading some bank holding companies to move the issuance of structured notes from the bank holding company to a finance subsidiary. Although this move has been characterized in the press as exploiting a loophole, it is not. Rather, the move is designed to restructure the bank holding company in order to make it easier for regulators to resolve in the event of another financial crisis. The issue is not that it is unsafe for the bank holding company to issue structured notes; rather the issue is that valuing structured notes quickly to facilitate an over-the-weekend resolution of a bank holding company using a single-point of entry resolution approach may be difficult. Moving the notes to a finance subsidiary avoids the weekend valuation problem.

Bank Holding Company Debt and Structured Notes

Since the Financial Stability Board first released its consultative document regarding the TLAC requirement for G-SIBs, it became clear that regulators were concerned about the difficulties associated with valuing, in the context of a resolution of a bank holding company, any structured products that had been issued. The Federal Reserve's notice of proposed rulemaking ("Fed NPR") noted that structured notes "contain features that could make their valuation uncertain, volatile, or unduly complex," and the difficulty associated with valuing structured notes would, in the Federal Reserve's view, make more challenging the orderly resolution of a failed bank holding company. The Fed NPR noted further that securities issued by bank holding companies ought to have easily ascertainable values. Perhaps to a lesser extent, the Fed NPR also expresses a concern that the purchasers of structured notes are interested principally in exposure to the underlying reference assets and less interested in being exposed to the credit of the bank holding company issuer.

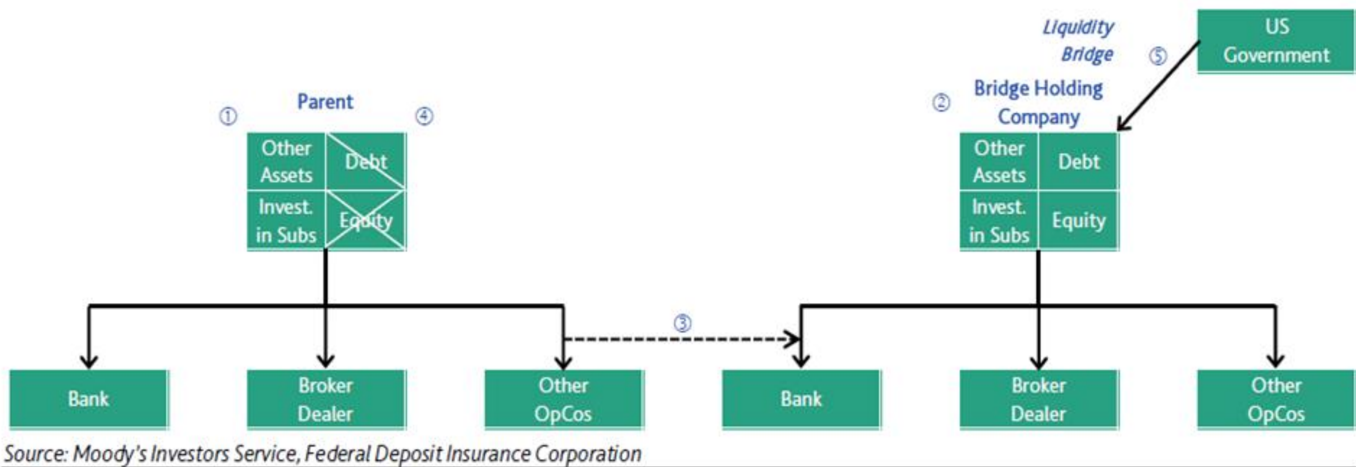
[2] This offering memorandum could have involved some rather unusual drafting sessions.
[3] We will not discuss in this article the issues that may have arisen from applicable privacy laws that apply to healthcare professionals.
[4] https://media2.mofo.com/documents/151015structuredthoughts.pdf.

Absence of Restrictions on Financings Undertaken by Subsidiaries

As a result of these views, the Fed NPR excludes structured notes from qualifying as eligible long-term debt for TLAC purposes. However, contrary to press reports, there is no "loophole" or "exemption" that would expressly permit the issuance of structured products by G-SIB subsidiaries—none is needed. The Fed NPR does not address and therefore does not purport to limit the types of securities that may be issued by a subsidiary of a G-SIB bank holding company. The eligible long-term debt and TLAC requirement is imposed as a means of promoting the feasibility of the single-point of entry resolution ("SPOE") approach outlined in the Dodd-Frank Act and by the FDIC. The Fed NPR also does not limit issuances of structured notes by bank subsidiaries (bank notes).

Single-Point of Entry Resolution

In various presentations, we have used the below FDIC diagram to illustrate the operation of the SPOE resolution approach:

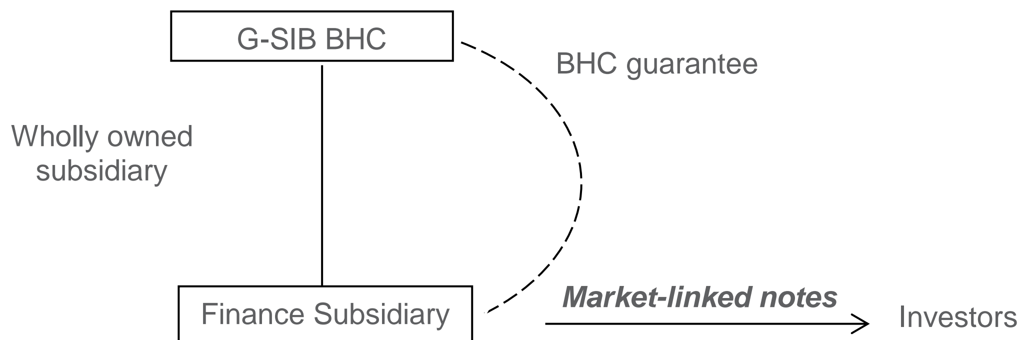


As illustrated by the diagram, the SPOE resolution scheme is focused principally on the liabilities of the parent G-SIB bank holding company and the orderly resolution of the bank holding company. If one were to posit that the views expressed in the Fed NPR are true, and that structured notes issued by the bank holding company are difficult to value (which is not a statement with which we would agree), it still would not lead to any need to any regulatory imperative to limit the issuance of structured notes at the subsidiary level.

Finance Subsidiary Issuance: an Illustration

Many U.S. G-SIB issuers of structured notes have established finance subsidiaries that issue, or that will issue, structured notes. There is no subterfuge involved in doing so. As explained above, the issuance of structured notes by a subsidiary of a G-SIB is not a scheme to evade the TLAC requirements. Also, the use of a finance subsidiary for funding purposes is not a new development or a new idea. Financial institutions and operating companies with frequent capital-raising needs have employed finance subsidiaries for decades in an open and transparent manner, both for structured products as well as plain vanilla notes.

The finance subsidiary approach can be illustrated by the following simplified diagram:



The finance subsidiary will be the issuer of the structured notes. The U.S. Securities and Exchange Commission definition (see Rule 3a-5 of the Investment Company Act) of a "finance subsidiary" is an entity whose primary purpose is to finance the business operations of its parent company or companies controlled by its parent company. As a result, the finance subsidiary will not have any operations other than issuing structured notes or other securities, on-lending the proceeds of such offerings, and entering into related hedging transactions with affiliates. The parent BHC will provide an unconditional guarantee; however, in order to comply with the "clean holding company" requirement set forth in the Fed NPR, the occurrence of a bankruptcy event relating to the parent BHC will not cause an event of default that would accelerate payments under finance subsidiary-issued structured notes.

Upon a failure of the parent BHC, the finance subsidiary-issued notes are not expected to convert into equity of the parent BHC or of a new bridge holding company. As contemplated by the SPOE resolution process, it is anticipated that the finance subsidiary-issued structured notes would remain outstanding. The guarantee would remain in effect, but it may not be assumed by the bridge holding company. The Federal Reserve Board has indicated that one of the many purposes of the new proposed regulations is to maintain market confidence and stability by keeping subsidiaries of a bank holding company operating after a failure of that bank holding company. However, because of the untested nature of the new regulatory regime, and the fact that bank regulators may exercise equitable and other discretionary powers, it is not possible to know in advance how, or whether, this goal will be met. As is the case with a structured note issued directly by a bank holding company, with structured notes issued by a finance subsidiary, in the event of a failure of the bank holding company, an investor is subject to the possibility of a complete loss of his or her investment.

Disclosure and Suitability Requirements

The finance subsidiary-issued securities are offered pursuant to a registration statement declared effective by the SEC. The same disclosure and liability standards that would apply to SEC-registered securities of the parent bank holding company are applicable to these securities. Similarly, for broker-dealers that participate in the distribution of the finance subsidiary-issued securities, the same standards relating to the suitability of recommendations remain applicable. Unfortunately, articles have suggested that offerings of finance subsidiary-issued securities would be subject to less onerous standards or to different or fewer regulatory requirements, which is simply not the case. Finally, although it should be apparent, the requirements related to eligible long-term debt and TLAC are not intended to address disclosure or suitability considerations. Disclosure issues would, in any event, be addressed by the SEC, and suitability or misselling concerns would be addressed by FINRA.

Credit-Linked Notes: Germany and the United States

In July 2016, Germany's Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "BaFin") announced its intention to prohibit the marketing, distribution, and sale of "credit-linked notes" to retail clients.[5]

In making this determination, BaFin indicated that it had significant investor protection concerns about credit-linked notes, particularly due to the relatively high degree of complexity of these products. With credit-linked notes, the interest and repayment of the money invested depend on the credit risks of reference entities. The return on these instruments will particularly depend upon whether a "credit event" relating to the underlying reference entity occurs – something which retail clients may not be able to assess or predict. They may not be able to assess the probability of repayment of the investment amount and/or whether they are being adequately compensated for the assumption of the credit risk.

In making this determination, BaFin also viewed the risk of a conflict of interest inherent in the product structure as potentially problematic. Issuers are, on the one hand, manufacturers of the credit-linked notes sold to retail clients. On the other hand, these issuers (or an affiliated entity) may also maintain business or lending relationships with the companies whose credit risk underlies the products.

Moreover, BaFin noted that the product name could be misleading and give rise to investor protection concerns. Despite what the German name may suggest, credit-linked notes ("Bonitätsanleihen") are not bonds ("Anleihen") in the traditional sense. That is, when analyzed economically, the role of the investor is not that of a typical (bond) lender; rather, the investor may be deemed to have a role similar to that of a protection seller who assumes the risk of the occurrence of a credit event. This confusion of roles may give retail clients the false impression that the product is a more typical interest-bearing security.

BaFin stated that its action results in part of its review of actual practices in its home market. BaFin examined the extent to which credit-linked notes are being actively sold to retail clients and whether the risks involved are explained in sufficient detail to those clients. BaFin found that issuers are producing credit-linked notes specifically for sale to retail clients. BaFin believes that those clients generally do not receive an adequate explanation of how the products work.

In the United States, credit-linked notes cannot be issued pursuant to a registration statement.[6] As a result, these instruments are currently offered to U.S. investors only in reliance on Rule 144A.

Recent Canadian Tax Proposals Further Amend the Tax Treatment of Linked Notes

This article was contributed by Jonathan Willson and Ryan Abrahamson of Stikeman Elliott LLP in Toronto, Canada.

On July 29, 2016, the Department of Finance (Canada) issued drafted legislation to amend the treatment of a sale of a linked note in a secondary market (the "July Proposals"). The July Proposals expand upon earlier tax proposals announced on March 22, 2016, as part of the Canadian federal budget ("Budget 2016").

Currently, the *Income Tax Act* (Canada) (the "Act") contains rules that deem interest to accrue on prescribed debt obligations, including most standard linked notes. The Act also contains a rule that provides that interest accrued to the date of the sale of a debt obligation is included in the income of the vendor for the year in which the sale occurs, provided that such amount is determinable. Based on the existing rules, investors have been able to sell their linked notes to third parties prior to the date that the full amount of the return would be included in income (e.g. prior to the date where the amount paid at maturity or an accelerated value is determinable). As such, these investors would take the position that no amount in respect of the return on a linked note is accrued interest on the date of the sale of the note. In effect, these investors converted ordinary income that is fully taxable to capital gains, of which only 50% of the amount is taxable.

[5] BaFin's release may be found at the following link: http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Pressemitteilung/2016/pm_160728_bonitaetsanleihen_allgemeinverfuegung_en.html.
[6] https://media2.mofo.com/documents/141201structuredthoughts.pdf.

To address the tax issues arising from the sale of linked notes in the secondary market, Budget 2016 proposed to amend the treatment of any gain realized on a sale of a linked note in a secondary market (the “March Proposals”). The March Proposals deem an amount to be accrued interest on the sale of linked notes. Specifically, the March Proposals require taxpayers to include in their income on the sale of a linked note as accrued interest the amount by which the price for which the debt obligation was assigned or transferred exceeds the price for which the debt obligation was issued (less any principal repayments). The March Proposals also permit taxpayers to deduct from the deemed accrued interest the portion of the amount that the sale price exceeds the issuance price (less any principal repayments) that is reasonably attributable to an increase in the value of “fixed rate interest payments” to be received under the debt obligation because of a decrease in market interest rates from the time of issue of the debt obligation to the time of sale (the “Fixed Rate Deduction”).

The July Proposals expand upon the March Proposals by providing a more detailed framework for calculating the Fixed Rate Deduction. Under the July Proposals, the Fixed Rate Deduction from the deemed accrued interest is equal to the amount that is reasonably attributable to the excess, if any, of the present value of all fixed rate interest payments to be received under the note after the date of assignment or transfer (the “Transfer Date”) over the present value of all fixed rate interest payments that would be received under a hypothetical debt obligation. For these purposes, the hypothetical debt obligation would have the same terms and conditions as the particular linked note (including the same issuer and maturity date) but would be issued on the Transfer Date and would bear a fair market interest rate determined at the Transfer Date.

While more specific than the March Proposals, the July Proposals leave linked note issuers and investors with considerable uncertainty. Particularly, issuers have not been provided with sufficient guidance as to what constitutes a “fixed rate interest payment”, nor have they been properly instructed on the Fixed Rate Deduction calculation. Ideally these issues will be resolved through the consultation process currently being undertaken by the Department of Finance in respect of the July Proposals.

FINRA TRACE Reporting and Time of Execution

In August 2016, the Financial Industry Regulatory Authority, Inc. (“FINRA”) released Regulatory Notice 16-30. The notice reiterates the requirement that member firms accurately report the time of execution for transactions on their Trade Reporting and Compliance Engine (“TRACE”) trade reports. The notice emphasizes that the “time of execution” of the transaction usually occurs when the parties “agree to all of the material terms sufficient to calculate the dollar price of the trade” or, more generally, when there has been a “meeting of the minds” as to the material terms of the transaction, including price and quantity.[7]

Regulatory Notice 16-30 highlights certain occasions where the time of execution reporting does not occur at the time the trade is entered into the firm’s system. These instances include where the trade is made after business hours, or where a firm sends an electronic notice to its counterparty, but the details of the transaction have already been agreed before the firm sends that notice. FINRA indicates that the time at which the material terms were agreed, rather than the time at which the firm sends the notice, is the time that would be reported on the TRACE report.

The notice contains a discussion relevant to the issuance of structured notes that are offered on a set calendar. The notice states that, for a new issuance, the time of execution is determined in the same manner as it would be for a secondary issuance – namely, when there is a meeting of the minds as to the material terms of the transaction. Consequently, where a firm receives “a firm commitment to purchase a TRACE-eligible security when it is issued, but prior to the final pricing or determination of other material terms of the new issue, the time of execution has not yet occurred.”[8] The notice confirms that a meeting of the minds “cannot occur before the final material terms, such as price, coupon and quantity have been established by the issuer, and such terms are known by the parties to the transaction.” As firm orders for structured notes are taken before the final terms of the notes are set on the applicable pricing date, the correct time of execution for the report will be on the pricing date, once the material terms have been finalized.

[7] FINRA Notice 16-30 at 1.
[8] *Id.* at 2.

FINRA Re-Proposes Enhanced Pricing Disclosure on Customer Confirmations in Connection with Fixed Income Transactions

On August 12, 2016, FINRA proposed to amend FINRA Rule 2232 to require FINRA members to provide additional pricing information on retail customer confirmations for non-municipal fixed income transactions (the "New Proposal").[9] The New Proposal revises to some extent FINRA's prior proposal from October 2015 (the "Revised Proposal"),[10] which was initially issued in November 2014.[11]

Under the New Proposal, if a member trades as principal with a non-institutional customer in a corporate debt[12] (including, for example, a structured note) or agent debt[13] security, the member would, subject to certain exceptions, be required to disclose the member's mark-up or mark-down from the prevailing market price for the security on the customer confirmation. Rule 10b-10 under the Exchange Act already requires that FINRA members provide customers with limited pricing information (e.g., transaction cost information) in connection with transactions in equity securities where the member acts as principal; however, no such requirement currently exists for transactions in fixed income securities.

Requirements Under the New Proposal

In response to the Revised Proposal, several commenters expressed that retail investors would also benefit from more enhanced price disclosure. Accordingly, the New Proposal would further amend FINRA Rule 2232 by requiring member firms to provide additional pricing information on customer confirmations in connection with non-municipal fixed income transactions with retail customers. Where a member trades as principal with a non-institutional customer in a corporate debt or agency debt security, the member would be required to disclose the member's mark-up or mark-down from the prevailing market price for the security on the customer confirmation.

Scope of the Requirements Under the New Proposal. The disclosure requirements under the New Proposal would apply where:

- a member buys (or sells) a security on a principal basis from, or to, a non-institutional customer and engages in one or more offsetting principal trades on the same trading day in the same security; and
- the size of the member's offsetting principal trade(s) equals or exceeds, in the aggregate, the size of the customer trade.

The New Proposal defines a "non-institutional customer" as a "customer account that is not an institutional account." FINRA notes in the New Proposal that requiring disclosure for retail customers (as opposed to institutional accounts) is appropriate, because retail customers frequently have less access to market and pricing information than institutional customers. To reduce the implementation costs associated with the New Proposal, the New Proposal utilizes the same definition of "institutional account" under FINRA Rule 4512(c) in an attempt to define the scope consistently with the definition in other rule contexts.

Same-Day Triggering Timeframe. The New Proposal would require disclosure of the mark-up or mark-down where a firm's offsetting principal trade(s) equal (or exceed) the size of the customer trade on the same trading day.

In response to the Revised Proposal, several commenters expressed that the window for "triggering disclosure" should be limited to two hours—a two-hour window would be implemented more easily and more closely capture riskless principal

[9] *See* Proposed Rule Change Relating to FINRA Rule 2232 (Customer Confirmations) to Require Members to Disclose Additional Pricing Information on Retail Customer Confirmations Relating to Transactions in Fixed Income Securities (the "New Proposal"), SR-FINRA-2016-032 (Aug. 12, 2016), *available at* http://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2016-032.pdf.

[10] *See* Pricing Disclosure in the Fixed Income Markets, Regulatory Notice 15-36 (Oct. 2015), *available at* https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-15-36.pdf.

[11] *See* Pricing Disclosure in the Fixed Income Markets, Regulatory Notice 14-52 (Nov. 2014), *available at* https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_14-52.pdf.

[12] "Corporate debt security" is defined under the New Proposal as a "debt security that is U.S. dollar-denominated and issued by a U.S. or foreign private issuer and, if a 'restricted security' as defined in [Securities Act of 1933, as amended (the "Securities Act"),] Rule 144(a)(3), sold pursuant to Securities Act Rule 144A, but does not include a Money Market Instrument as defined in [FINRA] Rule 6710(o) or an Asset-Backed Security as defined in [FINRA] Rule 6710(cc)." *See* New Proposal, *supra* note 9 at 474.

[13] "Agent debt" has the same meaning under the New Proposal as provided under FINRA Rule 6710(1). *See* New Proposal, *supra* note 9 at 474.

trades, in line with the proposed disclosure requirements under Rule 10b-10 under the Exchange Act for equity securities. While FINRA acknowledges in the New Proposal that its review of statistics generated by the Trade Reporting and Compliance Engine indicates that the majority of firm principal/customer trades that occur within the same trading day occur within 30 minutes of one another, FINRA explains that there are several benefits to requiring disclosure more broadly for trades that occur within the same trading day, including:

- ensuring that more investors receive mark-up or mark-down disclosure;
- making member firms less likely to alter their trading patterns in response to the New Proposal, because members would be required to hold positions overnight to avoid having to make the proposed disclosure; and
- diminishing the variability that exists between the prices paid in firm principal/customer trades that occurred close in time to one another and the prices paid in firm principal/customer trades that did not occur close in time to one another.

Non-Arm's-Length Affiliate Transactions. Where a member firm buys from, or sells to, certain affiliates, the New Proposal would require the firm to "look through" the member's transaction with the affiliate to the affiliate's transaction with a third party in order to determine:

- when the security was acquired; and
- whether the "same trading day" requirement discussed above has been triggered.

Specifically, the New Proposal requires that the "look through" be applied where a member's transaction with its affiliate was not at "arm's-length." The New Proposal defines "arm's-length transaction" as any transaction that was "conducted through a competitive process in which non-affiliate firms could also participate" (e.g., pricing was sought from multiple firms or the posting of multiple bids and offers) and where the affiliate relationship did not include the price paid or proceeds received by the member.

Exemptions from the Disclosure Requirement. The New Proposal provides two exemptions from the proposed disclosure requirement for: (1) functionally separate trading desks; and (2) fixed-priced offerings.

First, a firm will be exempt from the disclosure requirement if the non-institutional customer transaction was executed by a principal trading desk that is functionally separate from the principal trading desk within the same member firm that executed the member purchase (in the case of a sale to a customer) or member sale (in the case of a purchase of a customer) of the security.

To qualify for this exemption, however, the member firm must have in place policies and procedures reasonably designed to ensure that the functionally separate principal trading desk through which the member purchase (or member sale) was executed had no knowledge of the customer transaction.

Second, a firm will be exempt from the disclosure requirement if the member:

- acquired the security in a fixed-price offering (including an underwritten offering); and
- sold the security to non-institutional customers at the fixed-price offering on the day the securities were acquired.

Future Action by the Securities and Exchange Commission

The SEC published notice to solicit comments on the New Proposal on August 15, 2016, in the *Federal Register*—comments to the New Proposal were due by September 5, 2016 (i.e., 21 days after its publication).

SEC Rule 206(3)-3T to Sunset on December 31, 2016

On August 19, 2016, the Securities and Exchange Commission ("SEC") stated in a letter that it will not take further action to extend the sunset date of SEC Rule 206(3)-3T, which is set to expire on December 31, 2016.[14] The SEC first adopted

[14] Letter from David W. Grim, Director, SEC Division of Investment Management, to Ira D. Hammerman, Executive Vice President and General Counsel, SIFMA, *Rule 206(3)-3T under the Investment Advisers Act of 1940* (Aug. 19, 2016) *available at* https://www.sec.gov/divisions/investment/guidance/staff-letter-sifma-081916.pdf.

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Rule 206(3)-3T in 2007 to provide an alternative means for investment advisers that are also registered with the SEC as a broker-dealer ("Dual Registrants") to comply with Section 206(3) of the Investment Advisers Act ("Advisers Act") when they act in a principal capacity in transactions with certain advisory clients.[15] In December 2010, the SEC extended the sunset provision on the rule to December 13, 2012. Subsequent amendments to the rule extended the sunset date again, pending completion of a study of the regulatory requirements applicable to broker-dealers, mandated by Section 913 of the Dodd-Frank Act.

In its August 2016 letter, the SEC noted that few firms currently rely on Rule 206(3)-3T, and, as such, it has decided not to take further action to extend the sunset date of the rule. Individual exemptive relief may be available upon application to the SEC, where firms can provide a similar means of compliance with Section 206(3) of the Advisers Act.

Background of Rule 206(3)-3T

Under Section 206(3) of the Advisers Act, Dual Registrants must provide written notice and obtain client consent on a transaction-by-transaction basis when trading as a principal with a client. Rule 206(3)-3T provided Dual Registrants with an alternative means to comply with Section 206(3), while still requiring transaction-by-transaction disclosure. Specifically, the Rule permitted a Dual Registrant to engage in principal transactions with a nondiscretionary advisory client, subject to the following conditions:

- *Blanket Written Notice and Revocable Consent*. The Rule required the Dual Registrant to provide the client with a blanket written prospective notice and obtain the client's blanket written revocable prospective consent with respect to principal transactions.
- *Eligible Securities*. The Rule applied to any principal trade that did not involve (1) a security issued by the Dual Registrant (or by an affiliate of the Dual Registrant), or (2) a transaction in which the Dual Registrant (or an affiliate of the Dual Registrant) acted as underwriter, other than offerings of non-convertible investment grade debt securities.[16]
- *Trade-by-Trade Disclosure/Client Consent*. The Rule required that the Dual Registrant, prior to the completion of each principal transaction, must (1) inform the client that the Dual Registrant is acting as principal for its own account with respect to the transaction, and (2) obtain consent from the client for the transaction. The trade-by-trade disclosure and consent may be written or oral.
- *Confirmation Disclosure*. The Rule required that the confirmation provided to the client under Rule 10b-10 of the Exchange Act, at or before completion of the transaction, indicate in plain English that (1) the Dual Registrant disclosed to the client prior to the execution of the transaction that it may act in a principal capacity in connection with the transaction, (2) the client authorized the transaction, and (3) the Dual Registrant sold the security to or purchased the security from the client for its own account.
- *Annual Report*. The Rule required that the Dual Registrant provide the client with a list of all principal trades that were executed in the client's account during the prior year, including the dates and prices of the transactions.

With the sunset of the temporary rule, Dual Registrants will need to comply with the more cumbersome provisions of Section 206(3), in the absence of any further regulatory relief.

[15] The adopting release is available at https://www.sec.gov/rules/final/2010/ia-3128.pdf.
[16] As noted above, the exemption for non-convertible investment grade debt securities underwritten by an affiliated broker-dealer did extend to structured products that are investment grade debt. Thus, for principal trades in structured products underwritten by an affiliate, the investment adviser must obtain consent on a trade-by-trade basis.

Upcoming Events

Getting Ready for PRIIPs
Morrison & Foerster Teleconference

Tuesday, September 20, 2016
11:00 a.m. – 12:00 p.m. EDT

The PRIIPs disclosure regime in Europe will affect most sectors of the retail investment products industry—securities, funds, deposits, and insurance, as well as derivatives. The Regulation is due to apply from January 1, 2017, and, therefore, understanding and implementation of the detailed requirements for Key Information Documents by issuers and other PRIIPs "manufacturers," both EU and non-EU, has taken on a renewed urgency.

This webinar will cover topics such as:

- Scope of the PRIIPs Regulation;
- Product descriptions;
- Updates of KIDs;
- MRM and the categorization of PRIIPs;
- Performance scenarios; and
- Compliance deadline & grandfathering.

Speakers:

- Peter J. Green
  Partner, Morrison & Foerster LLP
- Jeremy C. Jennings-Mares
  Partner, Morrison & Foerster LLP

To register or for more information, click here.

CLE credit is pending for New York and California.

Structured Products Washington Conference 2016
Morrison & Foerster Sponsorship
Wednesday, November 9, 2016

The Washington Court Hotel
525 New Jersey Avenue NW
Washington, DC 20001

The 4th annual Structured Products Washington D.C. conference will be returning to the capital on November 9, with the program showcasing the latest developments in the legal, regulatory and compliance landscape for structured products.

For more information, or to register, visit http://www.structuredproductswashington.com/.

Join our *Structured Thoughts* LinkedIn Group

Morrison & Foerster has created a LinkedIn group, *StructuredThoughts.* The group will serve as a central resource for all things Structured Thoughts. We have posted back issues of the newsletter and, from time to time, will be disseminating news updates through the group.

To join our LinkedIn group, please click here and request to join or simply e-mail Carlos Juarez at cjuarez@mofo.com.

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Morrison & Foerster was named 2016 Americas Law Firm of the Year for the second year in a row by *GlobalCapital* for its Americas Derivatives Awards.

Morrison & Foerster was named the 2016 Equity Derivatives Law Firm of the Year at the *EQDerivatives* Global Equity & Volatility Derivatives Awards.

Morrison & Foerster has been named Structured Products Firm of the Year, Americas by *Structured Products* magazine seven times in the last 11 years.

Morrison & Foerster was named Best Law Firm in the Americas four out of the last five years by *StructuredRetailProducts.com*

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