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Structured Thoughts

News for the financial services community.

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FDIC Adopts New Recordkeeping Requirements for Large Banks – Modifies Original Proposal as to Brokered CDs

In November 2016, the FDIC approved a final rule establishing recordkeeping requirements for insured institutions with a large number of deposit accounts. The rule is intended to facilitate rapid payment of insured deposits to customers if the institutions fail. The adopting release may be found at the following link: https://www.fdic.gov/news/news/press/2016/pr16101a.pdf.

Broker-dealers who sell structured CDs and other forms of brokered CDs will most likely be pleased that the FDIC revised some of the proposed provisions that would have been the most challenging in connection these types of products.

We discussed the proposed rule in our March 31, 2016 issue of this publication: https://media2.mofo.com/documents/160331structuredthoughts.pdf.

The rule applies to insured depository institutions with more than 2 million deposit accounts. (The FDIC expects that the rule will affect 38 U.S. banks.) Generally, the new rule requires these institutions to maintain complete and accurate data on each depositor. These institutions are also required to ensure that their IT systems are able to calculate the amount of insured deposits for most depositors within 24 hours of a failure.

The new rule provides a three-year period for developing the required recordkeeping and IT systems.

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In response to comments received in the FDIC's original proposal as to certain deposit accounts, including trust deposits, brokered deposits and other accounts that qualify for "pass through" deposit insurance coverage, the new rule establishes alternative requirements for these accounts. Under the final rule (and consistent with the recordkeeping requirements of 12 C.F.R. §§ 330.5 and 330.7), deposit records for these accounts may be maintained off-site with a third party, rather than at the issuing bank. The new rule also permits institutions to develop systems that process these accounts for a longer period after a failure, except for certain accounts that have "transactional features."[1]

Under the original proposals, access to account information could have changed significantly. Issuing banks would have needed to obtain this information from their brokers, in the new format required. Any sub-distributors used by the brokers would have needed to furnish this information up the distribution chain, so that it could reach the issuing bank. The FDIC's accommodation for brokered deposits removes this proposed requirement, making the rule more palatable for issuers of structured CDs that are sold through multiple broker-dealers.

IRS Partially Delays 871(m) Effective Date

On December 2, 2016, the IRS released Notice 2016-76 and followed through on its promise to provide taxpayers with guidance for complying with IRC Section 871(m) regulations. In the Notice, the Treasury Department and the IRS announced their intention to amend the IRC Section 871(m) regulations to phase in the application of certain rules to facilitate implementation of the regulations. The Notice acknowledged taxpayers' challenges in complying with certain aspects of the IRC Section 871(m) regulations and provides some relief. Most significantly, the Notice announces the Treasury Department's and the IRS's intention that the effective date for the application of Section 871(m) be January 1, 2017, for delta-one instruments and January 1, 2018, for non-delta-one instruments. See our client alert at https://media2.mofo.com/documents/161206-irs-guidance-871m.pdf.

SEC Commissioner References Recent RevCon Settlement in Big Data Speech

SEC Commissioner Kara M. Stein sees, through the use of new data tools and technology, an expansion of the SEC's ability to enforce its regulations in the evolving landscape of the financial markets.

Stein presented a keynote address called "A Vision for Data at the SEC" to the Big Data in Finance Conference at Michigan Law in Ann Arbor, Michigan, on October 28, 2016.[2] During her speech, Stein addressed the new opportunities that analysis of big data presents to the SEC.

One case of the SEC's incorporation of new data tools was discussed in a recent issue of this publication. In September 2016, the SEC instituted administrative proceedings against a broker-dealer, alleging that the broker-dealer's internal training materials used for certain structured notes were insufficient and that supervisors failed to adequately educate and train registered representatives who sold reverse convertible notes.[3]

According to the SEC's findings, the result of the alleged inadequate training led to the sale of reverse convertible notes to retail customer accounts, many of whom had identified themselves to the broker-dealer as having modest reported income and net worth, as well as primarily moderate or conservative investment objectives. The broker-dealer consented to the order without admitting or denying the findings. The order censured the broker-dealer and requires payment totaling over $15 million to settle the charges.

"What made that case unique was that, instead of traditional investigative techniques, it was built on custom analytics," said Stein. "Using this technique, they were able to identify over 8,000 retail customers for whom the investment in the complex debt instruments was inappropriate. A case like this may not have been possible in the past."

[1] "Transactional features" generally means that a depositor can perform transfers or withdrawals from the deposit account to make payments or transfers to third parties, for example, through checks or electronic transfers. This category is typically inapplicable to structured CDs.
[2] https://www.sec.gov/news/speech/speech-stein-10-28-2016.html.
[3] https://media2.mofo.com/documents/161005-structured-thoughts.pdf.

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Despite the use of the SEC's new data tools, Stein's vision for the future involves a more proactive approach. "I am much more interested in establishing rules of the road that can help prevent crashes than in waiting to deal with the aftermath. Better investor protection is avoiding fraud and misconduct in the first place. The key question is how can we design policies and monitoring systems that support healthy market function and aid in compliance on the front end?"

For additional information regarding the SEC's action on structured product training materials, see our firm's Structured Thoughts here.

SEC Chair Discusses Enforcement Record and Enforcement Priorities

In a November 2016 speech at New York University Law School's Program on Corporate Compliance and Enforcement, outgoing SEC Chair Mary Jo White addressed the SEC's recent enforcement strategies. [In part, the speech appears to represent a response to those who have asserted that the SEC has not proceeded aggressively enough in this area in recent years.] In this article, we summarize a few points that may be of particular relevance to the structured products industry. A full copy of the speech may be found at the following link: (https://www.sec.gov/news/speech/chair-white-speech-new-york-university-111816.html)

Enforcement Agenda. Ms. White emphasized the "bold and unrelenting" enforcement agenda that she pursued. She pointed out the SEC's record of enforcement actions, monetary remedies, and the restitution of funds to investors who inappropriately lost money.

Use of Data. Ms. White discussed the SEC's increased use of data analytics to detect and investigate misconduct and described the SEC's growing number of in-house analytical tools to examine data. She summarized how these tools supported cases against different individuals and entities. (See also our article above, "SEC Commissioner References Recent RevCon Settlement in Big Data Speech.")

Whistleblowers. Ms. White summarized how whistleblowers have emerged as key sources of significant cases that the SEC has brought. Ms. White expects the SEC's whistleblower program to increase in importance in coming years, and the SEC has attempted to "change corporate attitudes" and to enhance the protection afforded to whistleblowers.

Proceeding Against Individuals. While not referencing any specific cases, Ms. White noted:

"Holding individuals liable for wrongdoing is a core pillar of any strong enforcement program. A company, after all, can only act through its employees, and to have a strong deterrent effect on market participants, it is absolutely critical that responsible individuals be charged and that we pursue the evidence as high as it can take us…the Commission's actions over the past three plus years show the priority that we are placing on establishing individual liability."

However, Ms. White also noted that in certain areas, such as improper sales and disclosure practices of complex products at major financial institutions, it has been much more difficult to hold senior executives responsible; for example, those senior officers are often not directly involved in the relevant activities. Ms. White noted the principles behind the laws of certain non-U.S. jurisdictions, in particular the U.K.'s "Senior Manager Regime"; this statute is designed to incentivize executives and other senior managers to take greater responsibility for the actions of the employees that they supervise. This regulation makes it easier for the authorities to hold more individuals accountable for offenses that occur in areas of the executives' responsibilities, even if the executive is not involved in the misconduct, does not know about it, and does not directly supervise the offending employees. This regulatory framework can hold these executives liable if they did not take "reasonable steps" to prevent the relevant misconduct. Ms. White encouraged the United States to follow developments under this type of statute and what it may teach about potential changes to the U.S. regulatory regime to encourage better compliance with applicable laws.

Conditional Offers to Buy

In this publication, we often write about offering features used outside of structured products that find their way into the structured products market. In this article, we write about how an offering methodology used for several years in the structured products world has made its way to another market, namely the IPO market.

In a recent no-action letter,[4] the SEC's Division of Corporate Finance agreed that a broker-dealer's proposed procedures for selling securities in an IPO through conditional offers to buy would not constitute a pre-effective sale. Accordingly, these procedures would not violate Section 5(a) of the Securities Act.[5] The procedures in question will look familiar to those market participants who work on registered offerings of structured products.

Under the procedures, the IPO shares will be offered to the broker-dealer customers based upon the range in the IPO price that is set forth in the red herring, as required by the SEC's rules. This range in share price is somewhat analogous to the ranged cap, multiplier, interest rate, or other term that may exist in the red herring for a structured note offering, and the final term depends in part upon market conditions on the pricing date. During the offering period, these accounts may place a "conditional offer to buy" ("COB") with their broker; the COB will only transform into an actual order if the offering price is within the range. The investor is also permitted to cancel its order prior to the expected time of effectiveness of the registration statement.[6]

This offering methodology, like that of structured notes, was designed to facilitate offerings of these products to retail investors. Unlike institutional investors, which are prepared to monitor the markets and effect securities transactions at just about any point in the trading day, retail investors cannot be expected to stand ready to confirm a prior indication of interest at exactly the time when an offering's final terms are set. Accordingly, a procedure that permits a COB to be made, and to be transformed into an actual order at the time that the final terms are set, permits retail investors to participate in the offering, based on a range of terms that they have agreed to at the time they placed their COB. Not all investors can be reached by telephone or email at the precise time the offering's terms are set.

SEC Approves FINRA Rules for Enhanced Pricing Disclosure for Fixed-Income Securities

In November, 2016, the SEC announced that it has approved FINRA's proposal that will require broker-dealers to disclose on retail customer confirmations the "mark-up" or "mark-down" for most sales in corporate and agency debt securities.[7]

The SEC's approval may be found at the following link: https://www.sec.gov/rules/sro/finra/2016/34-79346.pdf.

Under the new rule, if a broker-dealer buys or sells a corporate fixed-income security (including a structured note) to or from a retail customer and on the same day buys or sells the same security as principal from another party in an equal or greater amount, the firm will be required to disclose on the customer confirmation the firm's mark-up or mark-down from the market price. The confirmation would also have to provide the execution time and access to trade-price data in the TRACE system.

The new rules do not apply to securities purchased in fixed-price offerings, such as most initial offerings of structured notes.

The effective date of the new rule is expected to be announced shortly.

For additional discussion of these rules, please see the September 14, 2016 edition of this publication, which can be found at the following link: https://media2.mofo.com/documents/160914-structured-thoughts.pdf.

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[4] The no-action letter can be found at the following link: https://www.sec.gov/divisions/corpfin/cf-noaction/2016/morgan-stanley-smith-barney-112216-sec5.htm.

[5] In offering structured notes from an effective registration statement, there is typically no issue about violating Section 5(a)'s ban on pre-effective sales because the registration statement is already effective.

[6] Procedures of this type were discussed, for example, in the responses of several issuers to the SEC's April 2012 "sweep letter" relating to structured notes. (Question 7: Some issuers offer structured notes using a preliminary pricing supplement or term sheet that discloses a range for certain material terms (such as a capped maximum return), with the actual terms set within that range on a later pricing date. If you offer notes in this manner, explain to us with a view toward disclosure, how the size of the range is determined, how the actual terms are established, and when and how the actual terms are communicated to investors.)

[7] At the same time, the SEC approved a similar proposal from the Municipal Securities Rulemaking Board (the "MSRB"), which harmonizes the requirements between the FINRA and MSRB rulebooks.

What Is the Future of the DOL Fiduciary Rule?

The election of Donald Trump and the retention of Republican majorities in both houses of Congress has led many to question whether or not the "DOL Fiduciary Rule" can survive. The Rule was harshly criticized by some of Trump's advisers and, earlier this year, Congress passed legislation that would have blocked implementation of the Rule had the legislation not been vetoed by President Obama. As discussed in this Note, while the ultimate fate of the DOL Fiduciary Rule is far from clear, we believe there are significant obstacles to a quick repeal. As a result, broker-dealers, advisers, and banks should continue to plan for implementation of the Rule.

Background

On April 10, 2016, the U.S. Department of Labor ("DOL") adopted the DOL Fiduciary Rule, which expands the category of person who would be deemed a fiduciary when dealing with retail retirement accounts.[8] Under the new Rule, a broker-dealer or other financial intermediary ("Financial Institution") could be deemed a "fiduciary" based on a single instance of making a suggestion to a retail retirement account regarding investments or investment strategies. As a fiduciary, the Financial Institution would be required to act in the "best interest" of the client. Moreover, as a fiduciary, the Financial Institution would not be allowed to receive commissions or other variable compensation in connection with transactions effected for a retail retirement investor unless the Financial Institution complies with one of two new exemptions adopted by the DOL: the Best Interest Contract Exemption ("BIC Exemption") or the Principal Transactions Exemption ("Principal Exemption"). Both exemptions pose substantial compliance burdens for Financial Institutions and the Principal Exemption is only available for a limited class of securities. In addition, neither exemption would permit a Financial Institution to underwrite the distribution of investment products issued by an affiliate.

The DOL Fiduciary Rule became effective on June 7, 2016. However, the rule includes a transition period that allows Financial Institutions to delay implementation until April 10, 2017, with some provisions not becoming applicable until January 1, 2018.

What Lies Ahead?

The DOL. Under new leadership, the DOL could propose rules that would modify, supersede, and/or repeal the current DOL Fiduciary Rule. However, because the current rule is already in effect, this would require going through the full notice and rulemaking process as set forth in the Administrative Procedure Act ("APA"), and DOL would be required to undertake a full cost-benefit analysis. This process could take many months. The new secretary of labor would not have the authority to unilaterally revoke the DOL Fiduciary Rule.

Alternatively, the DOL might invoke the "good cause" exception in the APA to further delay the implementation dates, thereby buying itself time to go through a more considered rulemaking process. Any action taken by DOL under the good-cause exception could be subject to judicial challenge.

Congress. More than 60 legislative days have passed since the DOL Fiduciary Rule was submitted to Congress. Therefore, the Congressional Review Act is no longer available to block the rule. Congress could pass new legislation intended to kill the DOL Fiduciary Rule. One example of such legislation is the Financial Choice Act introduced by Representative Hensarling in September 2016. Any such legislation might run afoul of a filibuster in the Senate, which could only be overcome with the support of some Democrats.

The Courts. The DOL Fiduciary Rule has been challenged by half a dozen lawsuits filed by various industry groups. The initial rulings in the two cases thus far decided were in favor of DOL. To the extent the pending cases continue beyond January 20, 2017, the Trump administration could decide not to defend them. In such event, it is possible that the courts would permit others to assume the defense of the new rule.

The White House. No doubt the course of events will be significantly influenced by policy decisions made in the White House. In this regard, it is not clear whether President-elect Trump is prepared to spend significant political capital to

[8] As used in this article, "retail retirement accounts" refers to IRAs and retirement plans that would not qualify for the "seller's exception" set forth in the DOL Fiduciary Rule. That exception is generally available to plans managed by a bank, insurance carrier, broker or investment adviser, or another professional fiduciary with at least $50 million under management.

repeal a rule ostensibly intended to protect middle-class retirement investors. In any event, repeal of the DOL Fiduciary Rule does not appear to be a top priority for the incoming administration, which has more than a full plate awaiting it.

The Industry. While some Financial Institutions remain adamantly opposed to the DOL Fiduciary Rule, a number of leading firms have indicated that they have moved too far toward implementation to stop the process. Moreover, a number of Financial Institutions seem reconciled to the concept that they will be required to act in the "best interest" of their clients, although relief from some of the more draconian provisions of the BIC Exemption and the Principal Exemption would no doubt be appreciated.

Conclusion

There are simply too many moving pieces and too many unknowns to accurately forecast the future of the DOL Fiduciary Rule. Under these circumstances, it would be prudent for Financial Institutions to proceed with their implementation planning, while keeping a close watch on political and judicial developments.

Shaping MREL for European (and non-European) Banks

The European Commission ("Commission"), on November 23, 2016, released its legislative proposals to amend the EU's Bank Recovery and Resolution Directive ("BRRD") to provide more detailed rules relating to the setting of MREL[9] for European banks, and to implement the Financial Stability Board's final principles for total loss-absorbing capacity ("TLAC") for global systemically important banks ("GSIBs"). MREL constitutes unsecured debt and other instruments that are considered to have good loss-absorbing abilities in the event of a bank's resolution and is substantially similar in nature to TLAC.

Under BRRD, derivatives liabilities are excluded from MREL eligibility, though liabilities from securities embedding a derivative, such as structured notes, are not currently excluded. In harmonising the MREL requirements with the TLAC requirements, the expectation was that structured notes would also be excluded from MREL eligibility, as they are excluded for TLAC eligibility.

The Commission's proposals in this regard are different for EU GSIBs and non-GSIBs. Structured securities will not be eligible for a GSIB's minimum MREL requirements, i.e. 16%/18% of risk-weighted assets and 6%/6.75% of the Basel III leverage ratio denominator as from January 1, 2019/2022. However, they will be eligible for any additional MREL requirements imposed on the GSIB by the relevant resolution authority and also for a non-GSIB's MREL requirements, in each case so long as they meet certain conditions. These conditions are that: (a) a given amount of the liability is known at the time of issuance, is fixed, and is not affected by a derivative feature; and (b) neither the instrument, nor its derivative feature, is subject to a netting agreement, and its value would therefore not be determined on a net basis under BRRD. However, only that part of the instrument meeting the requirements in clause (a) may be counted towards MREL.

If the current proposals are enacted, this appears to mean that principal-protected structured notes should be eligible to count towards a non-GSIB's MREL and towards any GSIB's MREL requirements above the minimum level, in each case to the extent of the principal-protected amount. This reflects the fact that the principal-protected part (if any) of a structured note does not suffer from the valuation difficulties that exclude other derivatives and derivative-linked liabilities from being considered easily bail-inable in a bank resolution.

MREL, though, is set by each resolution authority on a bank-by-bank basis, and it is open to the relevant EU resolution authority to require the relevant bank to subordinate its MREL-eligible principal-protected structured notes to liabilities that are not eligible for MREL. If required, this could be achieved either in the contractual terms of the note, or by provisions in the laws of the bank's jurisdiction of incorporation or by issuing the notes from a holding company that does not have any MREL-excluded liabilities ranking pari passu or junior to its MREL.

However, it is not immediately clear from the proposals why the Commission would make a distinction between GSIBs and non-GSIBs in terms of whether these types of structured notes should count towards MREL requirements. If it considers that such notes have good loss-absorbing capacity, one would not expect that to change, based on the type of bank issuing them. The current proposals place GSIBs at a competitive disadvantage to non-GSIBs in terms of raising MREL.

[9] MREL is the acronym for the Minimum Requirement for Own Funds and Eligible Liabilities, mandated by the BRRD.

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The market now eagerly awaits the final TLAC rules to be issued on December 15, 2016 by the U.S. Federal Reserve Bank, which has, no doubt, been studying the Commission's proposals carefully. [We will be reporting on those final rules as they are released.]

For a fuller description of the EU's proposed MREL changes, read our client alert.

Upcoming Events

Total Loss-Absorbing Capacity Update
Friday, December 16, 2016
Morrison & Foerster and SPA Teleconference, 8:30 a.m. – 9:00 a.m. EST

On Thursday, December 15, 2016, the Federal Reserve Board will hold an open meeting at which it will consider and approve a final rule relating to the total loss-absorbing capacity – or TLAC – requirement for U.S. banks that are G-SIBs and an internal TLAC requirement for foreign banks that are subject to a U.S. IHC requirement and are G-SIBs.

Join Morrison & Foerster and the Structured Products Association for a post-meeting analysis on changes from the proposed rule, with a focus on those changes affecting the structured products market.

The call will provide an overview of:

- The Fed's final TLAC, long-term debt and clean holding company requirements;
- Key differences from the proposed rule; and
- The effects for structured products.

Speaker: Oliver Ireland, Morrison & Foerster LLP

This will be an operator-assisted call. We invite you to submit questions before the start of the call. There will be no Q&A during or after the briefing.

In order to RSVP for this call, and to submit questions, click here.

Brexit: Impact on UK-Based Banks – Earthquake or Tremor?
Wednesday, January 11, 2017
PLI Webinar, 11:00 a.m. – 12:00 p.m. EST

Following the UK's vote in June 2016 to leave the EU, one of the major areas of concern has been the impact of Brexit on the UK banking sector. In addition to the UK banks, many international banks headquarter their European activities through branches or subsidiaries based in London. Topics will include:

- What is meant by the "single market" for financial services and the "EU passport"?
- "Hard Brexit" vs. "Soft Brexit": What do these terms mean in the context of banking and financial services? To what extent are UK-based banks likely to be able to maintain access to EU markets following Brexit in each scenario?
- When will banks need to make firm decisions about possible relocation of activities to other EU jurisdictions?
- What will be the impact of recent proposed changes to CRD4/CRR and the BRRD to non-EU banks carrying out activities in the EU?
- In its G20 memo, the Japanese government asked for certainty and transparency in the Brexit negotiations. What are the chances?

Speakers: Peter Green and Jeremy Jennings-Mares, Morrison & Foerster LLP
To register or for more information, click here.

Join Our *Structured Thoughts* LinkedIn Group

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

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

Contacts

Bradley Berman
New York
(212) 336-4177
bberman@mofo.com

Hillel T. Cohn
Los Angeles
(213) 892-5251
hcohn@mofo.com

Peter J. Green
London
44 (20) 79204013
pgreen@mofo.com

Lloyd S. Harmetz
New York
(212) 468-8061
lharmetz@mofo.com

Jeremy C. Jennings-Mares
London
44 (20) 79204072
jjenningsmares@mofo.com

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

Remmelt A. Reigersman
San Francisco
(415) 268-6259
rreigersman@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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