Morrison & Foerster News Bulletin

Volume 4, Issue 4 February 28, 2013

Structured Thoughts

News for the financial services community.

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Additional SEC Guidance on Estimated Value Disclosures

In February 2013, the Staff of the Division of Corporation Finance provided additional guidance to a number of issuers relating to their structured note disclosures.

Since the release of the SEC's "sweep letter" in April 2012,[1] market participants have been focused on revising their structured products offering documents to address the issues raised in the letter. The new guidance relates to the portions of the sweep letter that have generated the most discussion, that is, the new requested disclosures relating to the "estimated initial value" of structured notes and secondary market pricing practices.

Issuer Valuation. Elaborating on the sweep letter, the Staff noted that issuers must disclose the "issuer's valuation" on the cover page of the offering document, and share this information with investors prior to the time of sale. This estimated value should be based on the value of the "bond" element and the "derivative" element of the offered structured note. It seems that the Staff continues to think about a structured note as a "compound" security, comprised of two components. Disclosure documents should include a description of the estimated value, and any models used in the calculation of this amount. In calculating the value of the bond component, an issuer may use its internal funding rate or prevailing secondary market spreads.

In discussing the value of the derivative component that has factored into the estimated value, the issuer should discuss any valuation models or assumptions. The SEC noted that issuers should use mid-market inputs to estimate the value of the derivative component. If mid-market inputs are not used, issuers should disclose this fact, and the risk that the

[1] The sweep letter may be found on the SEC's website at the following link: http://www.sec.gov/divisions/corpfin/guidance/structurednote0412.htm.

embedded derivative is being valued differently than other similar derivatives.

Hedging Costs. The value of the derivative component should exclude the issuer's hedging costs. However, the new letter permits hedging costs to be included in the valuation under very limited circumstances:

- the issuer bids out the pricing of the embedded derivative to an unaffiliated third party as the sole method of valuing the embedded derivative;
- the issuer does not use any internal pricing model to value the embedded derivative for any reason; and
- the issuer discloses in the prospectus that it will engage in the derivative transaction with an unaffiliated third party.

In such a case, the issuer may use the unaffiliated third party's bid for valuing the embedded derivative, even though the unaffiliated third party's bid may already include its hedging costs. In this limited circumstance, the disclosure should indicate that the issuer's valuation includes the unaffiliated third party's estimated hedging costs as part of its bid price for the embedded derivative.

Other Costs. The SEC believes that the disclosures should also include narrative disclosure to explain (i) the fees, costs and other amounts that may be added to the issuer's valuation to calculate the original issue price of the structured notes and (ii) whether those amounts received from investors are used or retained by the issuer or an affiliate. As appropriate, the issuer may quantify such disclosed fees, costs and other amounts.

Risk Factors. As suggested by the sweep letter, and consistent with market practice, disclosure documents should include cautionary language alerting investors that the estimated value will be lower than the issue price of the notes. The disclosures should address any risks inherent in the valuation or pricing of the bond or derivative components, including the use of any assumptions or internal models. The risk factors also should alert investors that there will not be a liquid secondary market for the securities, and that secondary market prices may be lower than the issue price.

Conclusion. This guidance is applicable to all issuers of structured notes, and we would expect that disclosures will be revised to address this guidance and to reflect emerging best practices. Of course, each issuer and underwriter of structured notes has its own distinct business model, and a one-size-fits-all approach will not be appropriate. As a result, we anticipate that integrating many of these disclosure points and adapting disclosures to different issuance and distribution models will take some effort and careful thought.

2013 OCIE Examination Priorities Have Implications for Structured Products Issuers and Dealers

The National Examination Program of the Office of Compliance Inspections published its 2013 examination priorities on February 21, 2013. Several of the OCIE's examination priorities have implications for structured products issuers and dealers, particularly a focus on undisclosed conflicts of interest and unsuitable recommendations by broker-dealers of certain exchange-traded funds.

The OCIE identified conflicts of interest as a "leading indicator and cause of significant regulatory issues for individuals, firms, and sometimes an entire market." These conflicts of interest are a "particularly important challenge for large and complex financial institutions … due to these firms' extensive affiliations …." Under the OCIE's Broker-Dealer Exam Program, conflicts of interest were identified as an area of "ongoing risk," which means that the risk area is "common to all or many business models utilized by a particular category of registrant and [has] existed for a sustained period" and is likely to continue to be a risk in the foreseeable future. Areas of fraud in connection with sales practices regarding retail investors include conflicts of interest that "are not appropriately mitigated, and are not clearly disclosed in an understandable and timely manner."

For structured products, those conflicts could include, for example, the affiliations between the issuer and underwriter, and distribution and hedging fees that impact the pricing of the instruments.

The OCIE also highlighted its continuing concern with the suitability of recommendations of leveraged or inverse exchange-traded funds to retail investors. This concern was also raised by FINRA in its 2013 examination priorities letter.

The OCIE 2013 examination priorities letter can be found at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf.

EITF and the Federal Funds Rate

In a January 2013 meeting, FASB's Emerging Issues Task Force (the "EITF") voted in favor of adding the Federal Funds rate[2] as a benchmark rate under FAS 133. If this step is finalized, this change is expected to make hedging with derivatives based on the Fed Funds rate easier for market participants, with less impact on their income statements.

FASB Topic ASC 815, "Derivatives and Hedging," has been effective since 2008. To qualify for hedge accounting, Topic 815 provides rules and procedures for hedge effectiveness testing. If a derivative is ineffective, it is marked-to-market in the company's earnings. Topic 815 provides guidance on the risks that are permitted to be hedged in a fair value or cash flow hedge. Among those risks for financial assets and financial liabilities is the risk of changes in a hedged item's fair value or a hedged transaction's cash flows attributable to changes in the designated benchmark interest rate ("interest rate risk").

In the United States, currently only the interest rates on direct Treasury obligations of the U.S. government and LIBOR are considered to be benchmark interest rates that are eligible for hedge accounting treatment.

In reviewing the permissibility of the Federal Funds rate, the EITF recognized that, as a result of the financial crisis in 2008, the demand for hedging the Fed Funds rate has increased significantly. That demand has been driven by an increased focus by banks on their sources of funding (including an increased focus on overnight interbank borrowings of surplus balances held at the Federal Reserve), and new federal legislation designed to reduce systemic risks, such as legislation that requires greater clearing of derivatives through exchanges or clearinghouses (which must be collateralized).

For a change to take effect, the draft consensus will be released for public comment, and then the final guidance must be completed and published. After the effectiveness of the new guidance, market participants could treat Fed Funds as a benchmark rate for purposes of these transactions.

FDIC Proposes to Nix Insurance for Dually Payable Deposits

On February 12, 2013, the Federal Deposit Insurance Corporation proposed for public comment a rule that would exclude from federal deposit insurance coverage those deposits made at insured U.S. banks that are payable at a foreign branch of a U.S. bank, including those deposits that are payable both at domestic and overseas branches ("dually payable deposits"). The rule, however, also is intended to place a U.S. bank's dually payable deposits on an equal depositor preference footing with purely domestic deposits in the event of a bank resolution. The FDIC's action comes in large part as a direct response to action taken by UK regulators last fall to prohibit UK branches of a non-EU bank from taking deposits if those deposits are not accorded depositor preference status under the laws of the bank's home country.

For additional information about the proposed rules and their potential impact, please see our client alert, which may be accessed at the following link: http://www.mofo.com/files/Uploads/Images/130221-FDIC-Insurance-Deposits.pdf.

[2] The Federal Funds rate is the interest rate at which depository institutions such as banks actively trade balances held at the Federal Reserve with each other, usually overnight.

Structured Product Resources: European Legal and Regulatory Materials

Our Structured Products Resources page now features a section containing European legal and regulatory materials. The page includes links to a wide variety of materials that focus on the following topics:

- PRIPs;
- MiFID II
- Retail Structured Products;
- Benchmark Indices;
- UCITS and ETFs;
- The Alternative Investment Fund Management Directive; and
- The Prospectus Directive.

The page may be accessed at the following link: http://www.mofo.com/resources/european-structured-products/.

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

Morrison & Foerster named Best Law Firm of the Americas, 2012 by *StructuredRetailProducts.com*.

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