

IFLR Structured Products and Derivatives Forum

Considerations for Retail Providers and Distributors

February 3, 2011

Agenda

- Overview of the regulatory climate
- Regulatory developments in the US
- Regulatory developments in the EU
- Common themes

Overview

Critiques of structured products

- Structured products are not suitable for any investor, as they simply repackage otherwise available assets at a cost.
- Subject to credit risk.
- Lack of liquidity.
- Full of conflicts of interest.
- The popular financial press is still raising concerns regarding whether investors understand the structured products that are being marketed to them.
- The growth in structured product sales in the U.S., especially to retail investors, has piqued interest of regulators and industry groups.
- Attacks on the legitimacy of structured products as suitable for retail investors.

Regulatory Developments in the United States

Regulatory Developments

- FINRA developments
- ERISA developments
- Dodd-Frank related issues
- Regulatory inquiries and investigations

Recent FINRA Guidance

FINRA and Structured Products

- Why is FINRA so interested in structured products?
 - Wide retail distribution.
 - “Complex” security.
 - Many typical terms are not commonly found among “debt securities”:
 - Required payment of less than par at maturity.
 - No interest payments.
 - Significant possibility of intentional or accidental mis-selling: e.g., reverse convertibles.
 - Conflicts of Interest:
 - Most structured products (by volume) are issued by an affiliate of the lead underwriter.
 - Profits from underwriting discount, hedging transactions and unrelated trades in the underlying asset.

FINRA Guidance re Structured Products

- NASD Notice 05-26 re Reviewing New Products:
 - Members must develop and implement written procedures for offering new products:
 - What is a “new product”? The firm’s procedures should include clear, specific and practical guidelines for determining what is a “new product.”
 - The correct questions about the product must be asked and properly answered in advance.
 - Procedures should involve post-approval follow-up and review.
- NASD Notice 05-59 re Structured Products:
 - Members must provide fair and balanced disclosures as to the benefits and risks of structured products.
 - Members must ascertain which accounts should be eligible to purchase structured products.
 - Members must deal fairly with customers – familiarize themselves with customers’ situation, and make customers aware of appropriate information.
 - Members must perform “reasonable basis” and “customer specific” suitability determination.
 - Members must supervise and maintain a supervisory control system.
 - Members must properly train their personnel.

FINRA Guidance re Structured Products (con't)

- NYSE Information Memo 06-12 re Equity-Linked CDs:
 - Holders must understand risk of loss if instrument is sold before maturity.
 - Call risk.
- Regulatory Notice 09-31 re Leveraged and Inverse ETFs (June 2009)
- Regulatory Notice 09-73 re Principal-Protected Notes (Dec. 2009)
 - A FINRA response to the critiques of the “principal-protected” term and its use.
- Regulatory Notice 10-09 re Reverse Convertibles (Feb. 2010)
 - A FINRA response to widespread public criticism of sales practices in the area.
- Regulatory Notice 10-51 re Commodity Futures-Linked Securities (Oct. 2010)

FINRA Regulatory Notice 10-51: FINRA Reminds Firms of Their Sales Practice Obligations for Commodity Futures-Linked Securities*

- FINRA Regulatory Notice 10-51 focuses on four key areas:
 - Possible deviation between the performance of the commodity futures-linked security and the performance of the referenced commodity.
 - Ensure communications are fair and balanced and provide appropriate disclosures.
 - Conduct reasonable suitability assessments prior to recommending commodity futures-linked securities to customers.
 - Supervision and training of the firm's registered representatives.

*<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122289.pdf>

FINRA Regulatory Notice 10-51: FINRA Reminds Firms of Their Sales Practice Obligations for Commodity Futures-Linked Securities

- Possible deviation between the performance of the commodity futures-linked security and the performance of the referenced commodity:
 - The price movements of a futures contract are typically correlated with the movements of the referenced commodity's spot price, but the correlation is generally imperfect and price moves in the spot market may not be reflected in the futures market (and vice versa). Prices for futures contracts with more distant delivery dates can differ from each other as well as the spot price.
 - Commodity futures-linked securities can have different methodologies for achieving their investment objectives, and they may or may not employ strategies that address roll yield. Each strategy has different benefits, risks and costs, and the appropriateness of a particular methodology depends, in part, on the investor's needs and preferences.
 - The deviation between the performance of the commodity futures-linked security and the performance of the referenced commodity's spot price can produce unexpected results for investors who are not familiar with futures markets, or who mistakenly believe that commodity futures-linked securities are designed to track commodity spot prices.

FINRA Regulatory Notice 10-51: FINRA reminds Firms of Their Sales Practice Obligations Relating to Commodity Futures-Linked Securities

- Ensure communications with the public are fair and balanced and provide appropriate disclosures:
 - NASD Rule 2210: firms must ensure that all communications with the public: are based on principles of fair dealing and good faith; are fair and balanced; and provide a sound basis for evaluating the facts about any particular security or type of security, industry or service. No firm may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading.
 - Firms should not suggest that a commodity futures-linked security offers direct exposure to the commodity's spot price, overstate the degree of correlation between the two or understate the risks involved in investing in commodity futures.
 - Firms should also not overstate the hedging value of commodity futures-linked products, or commodities generally, for, by example, implying that their performance is always negatively correlated with equities or other asset classes.

FINRA Regulatory Notice 10-51: FINRA reminds Firms of Their Sales Practice Obligations Relating to Commodity Futures-Linked Securities

- Conduct reasonable suitability assessments prior to recommending commodity futures-linked securities to customers:
 - NASD Rule 2310: before recommending the purchase, sale or exchange of a security, the firm must have a reasonable basis for believing that the transaction is suitable for the customer to whom the recommendation is made.
 - For commodity futures-linked securities, the firm's registered representatives and the customer should discuss, among other things:
 - the commodity, basket of commodities or commodities index that a given product tracks;
 - the product's goals, strategy and structure;
 - that commodities prices, and the performance of commodity futures-linked securities, can be volatile;
 - that the use of futures contracts can affect the performance of the product as compared to the performance of the underlying commodity or index;
 - the product's methodology, including its strategy, if any, for managing roll yield and other factors that may affect performance; and
 - the product's tax implications.
 - Firms that sell commodity futures-linked securities must ensure that their registered representatives understand each product's goals, strategy and structure, and how those factors may affect the product's suitability for specific customers, given, among other things, the customers' investment objectives, investment horizons and tax status.

FINRA Regulatory Notice 10-51: FINRA reminds Firms of Their Sales Practice Obligations Relating to Commodity Futures-Linked Securities

- Supervision and training of the firm's registered representatives:
 - Firms that sell commodity futures-linked securities must provide adequate training to ensure that their registered persons understand the commodity futures-linked products they recommend, and that they describe them in a manner that is fair, balanced and not misleading.
 - Firms must also train registered persons about the characteristics, risks, and rewards of each product before they allow registered persons to sell that product to investors.
 - Firms should train registered persons about how to make customers aware of the pertinent information regarding the commodity futures-linked products and train them about the factors that would make the products either suitable or unsuitable for certain investors.
 - Training should not be limited to representatives selling the products. Firms should also provide appropriate training to supervisors of registered persons selling commodity futures-linked securities.
 - Firms must also have adequate written supervisory procedures and supervisory controls that are reasonably designed to ensure that sales of commodity futures-linked securities comply with the federal securities laws and FINRA rules.

FINRA Regulatory Notice 10-09: FINRA Reminds Firms of Their Sales Practice Obligations with Reverse Exchangeable Securities*

- FINRA Regulatory Notice 10-09 focuses on three key areas:
 - Communications with the public regarding the promotion of reverse convertibles.
 - Review suitability before recommending purchase.
 - Supervision and training of a firm's registered representatives.

*<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120920.pdf>

FINRA Regulatory Notice 10-09: FINRA Reminds Firms of Their Sales Practice Obligations with Reverse Exchangeable Securities

- Communications with the public regarding the promotion of reverse convertibles:
 - FINRA recommends firm representatives discuss the product with the customer to ensure the customer is making an informed decision. Specifically, the representative should explain:
 - how the product works and its payout structure;
 - the fact that the principal value of the investment is not guaranteed and a customer may suffer a loss on its investment;
 - the effect of sales prior to maturity, and the fact that the potential resale price may depend on the existence of a secondary market; and
 - if the firm publishes its own research report regarding the reference asset, the representative should disclose the content of the research and how (and whether) the research is relevant to a purchase recommendation.

FINRA Regulatory Notice 10-09: FINRA Reminds Firms of Their Sales Practice Obligations with Reverse Exchangeable Securities

- Communications with the public regarding the promotion of reverse convertibles (cont):
 - NASD Rule 2210: firms must ensure their communications with the public: are based on principles of fair dealing and good faith; are fair and balanced; and provide a sound basis for evaluating the facts about any particular security, industry or service.
 - Per NASD Rule 2210 firms cannot:
 - omit information if it would cause communication to be misleading, or
 - make false, exaggerated, unwarranted or misleading statements.
 - NASD Rule 2210 reminds firms that:
 - providing risk disclosure in a prospectus or supplement does not cure deficient disclosure in sales materials;
 - firm representatives should not suggest that reverse convertibles are ordinary debt securities; and
 - firms must not present annualized yield or coupon information for reverse convertibles in a misleading manner.

FINRA Regulatory Notice 10-09: FINRA Reminds Firms of Their Sales Practice Obligations with Reverse Exchangeable Securities

- Review suitability before recommending purchase:
 - NASD Rule 2310: firms must have a reasonable basis for determining that a product is suitable for investors in general and suitable for each specific customer prior to recommending the purchase or sale of a security.
 - NASD Rule 2310 requires firms to make reasonable efforts to obtain information concerning:
 - the customer's financial status;
 - the customer's tax status;
 - the customer's investment objectives; and
 - any other information considered reasonable by the member or registered representative in making recommendations to the customer.
 - The NASD's IM 2310-2(e) stresses a firm's obligation to deal fairly with customers when making recommendations or accepting orders for new financial products by making sure the firm familiarizes itself "with each customer's financial situation, trading experience, and ability to meet the risks involved with such products."
 - Eligible Accounts: firms should consider whether the purchase of reverse convertibles should be restricted to investors whose accounts have been approved for options trading.

FINRA Regulatory Notice 10-09: FINRA Reminds Firms of Their Sales Practice Obligations with Reverse Exchangeable Securities

- Supervision and training of a firm's registered representatives
 - Member firms are required to have written supervisory procedures and supervisory controls that are reasonably designed to ensure sales of reverse convertibles comply with federal securities laws and FINRA rules.
 - FINRA also requires firms to adequately train employees who sell, or supervise those who sell reverse convertibles. The training should focus on:
 - associated costs and risks of the product;
 - the terms and conditions of the product;
 - the reference stock, index or other asset;
 - the investment's potential for growth;
 - the product's liquidity before maturity; and
 - any other components that may impact suitability for general or specific customers.

FINRA Regulatory Notice 09-73: FINRA Reminds Firms of Their Sales Practice Obligations Relating to Principal-Protected Notes* (Dec 2009)

- FINRA Regulatory Notice 09-73 focuses on three key areas:
 - Ensure communications are fair and balanced and provide appropriate disclosures.
 - Conduct reasonable suitability assessments prior to recommending principal-protected notes to customers.
 - Train the firm's registered representatives.

*<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120596.pdf>

FINRA Regulatory Notice 09-73: FINRA Reminds Firms of Their Sales Practice Obligations Relating to Principal-Protected Notes

- Ensure communications are fair and balanced and provide appropriate risk disclosures
 - NASD Rule 2210
- Conduct reasonable suitability assessments prior to recommending principal-protected notes to customers
 - NASD Rule 2310
 - NASD IM 2310-2(e)
- Train registered representatives
 - Adequately train registered representatives regarding the terms, conditions, risks and rewards of these products

FINRA Investor Alert: Leveraged and Inverse Exchange Traded Funds (ETFs): Specialized Products with Extra Risks for Buy and Hold Investors* (August 2009)

- FINRA Investor Alert regarding leveraged and inverse ETFs focuses on two key areas:
 - Unique features of leveraged and inverse ETFs.
 - Recommended research investors should conduct prior to purchasing these instruments.

*<http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/P119778>

FINRA Investor Alert: Leveraged and Inverse Exchange Traded Funds (ETFs): Specialized Products with Extra Risks for Buy and Hold Investors (August 2009)

- Unique features of leveraged and inverse ETFs.
 - Similar to traditional ETFs, leveraged and inverse ETFs are typically registered investment companies whose shares represent an interest in a portfolio of securities that track an underlying benchmark or index with the shares of the ETF traded throughout the day on a securities exchange.
 - Differences from traditional ETFs:
 - Leveraged ETFs: Seek to deliver multiples of the performance of the index or benchmark they track.
 - Inverse ETFs: Seek to deliver the opposite of the performance of the index or benchmark they track (serving as a way to profit from, or hedge, an investor's exposure to downward moving markets).
 - Leveraged and Inverse ETFs are 'reset' daily and their performance over longer periods of time (weeks, months, or years) can differ significantly from the performance of their underlying index or benchmark.

FINRA Investor Alert: Leveraged and Inverse Exchange Traded Funds (ETFs): Specialized Products with Extra Risks for Buy and Hold Investors (August 2009)

- Recommended research investors should conduct prior to purchasing these instruments.
 - Due to the potential for extreme volatility between the underlying index and the leveraged or inverse ETF, FINRA recommends investors:
 - learn as much as possible about the ETF by carefully reading the prospectus before investing;
 - consider seeking the advice of an investment professional; and
 - ask the following questions:
 - How does the ETF achieve its stated objective? What are the risks?
 - What happens if I hold longer than one trading day?
 - Is there a risk that an ETF will not meet its stated daily objective?
 - What are the costs?
 - What are the tax consequences?

FINRA Guidance on Know Your Customer and Suitability

Recent Changes

- FINRA has adopted changes to FINRA Rule 2090 (Know Your Customer) and Rule 2111 (Suitability)
- The rules now:
 - Apply suitability determinations to recommended investment strategies (not only to recommendations relating to specific securities)
 - Identify three components to suitability: reasonable basis suitability, customer specific suitability and quantitative suitability
 - Would include in quantitative suitability that the broker-dealer make an assessment that a series of transactions, if viewed together, are suitable for a client
- Rule expands the items to be considered as part of a retail investor's profile to include: age, other investments, financial situation and needs, tax status, investment objectives, investment experience, time horizon, liquidity needs and risk tolerance

Recent Changes

- Addresses how customer suitability obligation may be discharged for institutional accounts
 - Broker-dealer may discharge if it has a reasonable basis to believe that the institutional customer is capable of evaluating the investment risks independently and the customer affirmatively indicates that it is exercising independent judgment in evaluating the recommendation
- “Institutional account” is defined to include an institutional investor with \$50 million in assets under management

Disclosures to Retail Investors

- FINRA Regulatory Notice 10-54 solicits comments on a Concept Proposal to require that members at or before commencing a relationship with a retail customer provide a disclosure statement
- The disclosure statement would describe:
 - The types of accounts and services the broker-dealer provides,
 - The conflicts associated with those accounts and services, and
 - Any limitations on the dates that the firm owes to retail customers
- Fees and services: the statement would disclose fees for each type of service or account and whether fees are negotiable
- Financial incentives: the statement would disclose the incentives that a broker-dealer may have to recommend certain products over others, as well as the terms of any referral arrangement

Disclosure Statement

- Dodd-Frank Act Section 913 requires that the SEC “facilitate the provision of simple and clear disclosures to investors regarding the terms of the their relationships with [broker-dealers] and investment advisers, including any material conflicts of interest.”
- Section 919 of the Dodd-Frank Act authorizes the SEC to issue new rules designating disclosure documents or information to be provided by broker-dealers to retail investors before the sale of any investment product or service

ERISA

Proposed ERISA Regulations

- October 21, 2010 DOL issued a proposed regulation that would expand the categories of persons considered fiduciaries as a result of their investment advice to ERISA plans or participants or beneficiaries of such plans
- Current regulation provides that a person is a fiduciary as a result of rendering investment advice to an ERISA plan, if the person:
 1. Renders advice as to the value of securities or makes recommendations as to the advisability of investing in, purchasing, or selling securities,
 2. On a regular basis,
 3. Pursuant to a mutual agreement or arrangement,
 4. That will serve as a primary basis for investment decisions with respect to plan assets, and
 5. That will be individualized based on the particular needs of the plan

Proposed ERISA Regulations

- Proposed regulation would expand significantly the categories of persons that would be considered fiduciaries as under the proposed regulation there is no requirement that advice be given on a regular basis nor that it serve as the primary basis for an investment decision

Dodd-Frank Related Developments

- The effect of the Dodd-Frank Act on the structured products market
 - Significant aspects of Title VII
 - Lincoln swaps “push-out” provision
- Required studies and rulemakings
- Investor protection aspects of the Act

Dodd-Frank Act, Title VII

Title VII provisions

- The Dodd-Frank Act creates a new regulatory structure for OTC derivatives
 - The SEC and the CFTC will have oversight responsibilities
 - Requires registration of swap dealers and major swap participants
 - Subjects most swaps to central clearing
 - Imposes new minimum capital requirements
 - Establishes broader position limits
 - Creates new business conduct standards

Effect of Lincoln (“Swaps Pushout”) Provision

- Intent of provision is to deny “federal assistance” to “swaps entities”.
- Mainly a concern for insured depository institutions, since such institutions can’t afford to be cut off from federal assistance.
- Under an exclusion in the Lincoln Provision, it appears that federal assistance should only be denied to an insured depository institution if it is a “swap dealer”.
 - So an insured depository institution can be a “major swap participant” without being cutoff from federal assistance—at least this is what a strict reading of the exclusion suggests.
 - However, this exclusion seems to conflict with, and be overridden by, another subsection of the Lincoln Provision (described below) that outlines permitted activities for an insured depository institution.

Effect of Lincoln (“Swaps Pushout”) Provision (cont’d)

- Lincoln Provision states that no federal assistance will go to an insured depository institution unless it limits its swaps activities to the following permitted activities: certain hedging/risk mitigation activities and swaps activities involving certain rates and reference assets:
 - Hedging/risk mitigation is permitted if directly related to depository institution’s activities:
 - No definition of “directly related”, so this will be matter of interpretation for banks and regulators
 - No limit on the types of transactions through which hedges may be effected—so presumably any kind of CDS could be executed as a hedge
 - Dealing and other swap activities are permitted for certain rates and reference assets, such as interest rates, exchange rates, precious metals, government, GSE and other agency obligations, various international development bank obligations, certain Canadian government obligations and investment grade corporate debt.
 - CDS are permitted as part of such dealing and other activities only if cleared

Effect of Lincoln (“Swaps Pushout”) Provision (cont’d)

- The scope of these permitted activities has generally been interpreted to require insured depository institutions to push out swap activities relating to equity securities, non-investment grade corporate debt and commodities (other than precious metals)
- Lincoln Provision’s likely implications, when considered with Volcker Rule/proprietary trading prohibitions, will be to:
 - Cause insured depository institutions to cease some or all of their swap dealer activities
 - Move swap activities relating to equities, commodities (other than precious metals) and non-investment grade debt to entities other than insured depository institutions
- The impact of the Lincoln Provision is uncertain for numerous reasons including the following:
 - What is the scope of the hedging activities that are permitted for an insured depository institution?

Effect of Lincoln (“Swaps Pushout”) Provision (cont’d)

- is any type of CDS hedging permitted, as wording seems to imply?
- if an insured depository institution is otherwise permitted to issue notes linked to equities, then is it permitted to execute swaps to hedge those equity linked notes, even though it isn’t permitted to be a dealer in equity swaps? Again, the language seems to support this interpretation.
- How will future regulations affect interpretation and scope of Lincoln Provision?
- To what extent will implementation of Volcker Rule combine with Lincoln to place even further restrictions on swaps activities of insured depository institutions and their affiliates?

Eligible Contract Participants

- Definition of Eligible Contract Participant (“ECP”) has been tightened for:
 - government entities, which now need \$50,000,000 (rather than \$25,000,000) of discretionary investments to qualify, and
 - individuals, who now need \$10,000,000 (\$5,000,000 if meet hedging test) in discretionary investments rather than total assets.
- Non-ECPs must execute swaps on a designated contract market (for swaps) or a national securities exchange (for security-based swaps). In other words, only ECPs may execute swaps OTC. No reference to swap execution facility for trades by non-ECPs.
- For security-based swaps, can’t buy from or sell to a non-ECP unless a registration statement is in effect with respect to the security-based swap.
 - Unclear how this requirement relates to swaps listed and trading on an exchange. Seems to be no reason why these should require a registration statement.
 - Perhaps rulemaking will clarify

Mandatory Clearing

- What must be cleared? Premise of the Act is that all swaps should be cleared, unless one of two exceptions is met:
 - no clearinghouse is willing to accept the swap for clearing, or
 - one of the parties to the swap qualifies to use the “commercial end user” exemption provided for in the Act.
- What swaps will be accepted for clearing?
 - two ways in which a swap is put on list of mandatorily cleared swaps:
 - CFTC/SEC can identify swap, or type, group or category of swaps, it believes should be cleared and initiate a regulatory review process to reach a determination about this. In this case, will have 30-day minimum public comment period.
 - a clearinghouse can identify swap, or type, group or category of swaps, it wants to clear and make submission to CFTC/SEC, which will commence a review and determination process. In this case, will have 30-day minimum public comment period, but CFTC/SEC must reach decision within 90 days after submission.

Mandatory Clearing (cont'd)

- we have little detail regarding how these review and determination processes will proceed. CFTC/SEC will need to adopt rules outlining the review and determination procedures. However, in making a determination, CFTC/SEC is to consider
 - outstanding notional exposure, trading liquidity and pricing data availability,
 - available infrastructure (rule framework, capacity, operational expertise, credit support) to clear swap on terms materially consistent with how it is currently traded,
 - effect on systemic risk mitigation, considering market size and clearinghouse resources,
 - effect on competition, and
 - legal certainty in case of clearinghouse failure.
- If CFTC/SEC believes swap should be cleared, but no clearinghouse will do so, CFTC/SEC can take additional actions, including additional margin and capital requirements, as it deems necessary in public interest—could have effect of taking that swap out of the market entirely.

Mandatory Clearing (cont'd)

- How will dealer be able to distinguish cleared from non-cleared swaps?
 - May be single most important issue for future development of OTC market.
 - Some fear that determinations will be riddled by a lack of clarity and precision, thus seriously impairing the ability of dealers to act with confidence when considering OTC trades.
 - However, some have expressed the contrary view that once some determinations are made it will quickly become obvious what trades can be differentiated from the cleared trades thereby allowing for robust OTC activity.

Mandatory Clearing (cont'd)

- What is effective date for clearing requirements?
 - Clearing requirements will be effective no earlier than 1 year after enactment or, if later, 60 days after rulemaking is completed if requirements depend on rulemaking (as they appear to).
 - Even after CFTC/SEC adopts rules establishing determination procedures, presumably a swap won't be subject to clearing requirement until the determination process has been applied to that swap. Prior to reaching a determination, swap should remain eligible for OTC activity, though will certainly need to be reported to data repositories.
 - For swap entered into prior to effective date of clearing requirements, still need to report these swaps to swap data repositories, within certain timeframes, to avoid retroactive application of clearing requirements.

Mandatory Clearing (cont'd)

- How may cleared swaps be executed?
 - cleared swap must be executed on contract market, securities exchange or swap execution facility
 - exception to this requirement if no such market, exchange or facility trades the swap or if, because of commercial end user exemption, swap is not required to be cleared
- What is scope of commercial end user exemption?
 - to use this exemption, must (a) not be “financial entity”, (b) be using swap to hedge “commercial risk” and (c) give notice to CFTC/SEC as to how generally will meet uncleared swap obligations. Also, public company must have board committee approval.
 - What is “commercial risk”?
 - not very difficult to identify for swaps based on physical commodities.
 - could present more challenging issue for swaps based on currencies and interest rates and for security-based swaps, since hedging may arguably relate to a financial activity.

Mandatory Clearing (cont'd)

- CFTC/SEC will define “commercial risk” by rule. Given strong statements in support of end-users made in Senate, hope is that these definitions will clarify (in favorable way) that from an end-user perspective commercial risk would include hedges for rates and currency exposure, as well as use of security-based swaps (e.g., issuer using equity swap to hedge in context of share buyback).
- “financial entities”, which can’t use this exemption, consist of swap dealers and major swap participants (both security and non-security based), commodity pools, certain private funds, certain pension plans and entities predominately engaged in defined banking activities
- Will be critical to confirm eligibility of OTC counterparties to use this exemption, with confirmation touching upon all elements noted above.
- NOTE: if swap is eligible for clearing, end-user may elect to clear it.
- Clearing only applies to “swaps” as defined.
 - options on a single security or a narrow based index are excluded from definition of swap and security-based swap
 - SEC already has jurisdiction over such options
 - Clearing (and other swaps related provisions of the Act, such as margin, capital, etc.) would not directly apply to these excluded options.

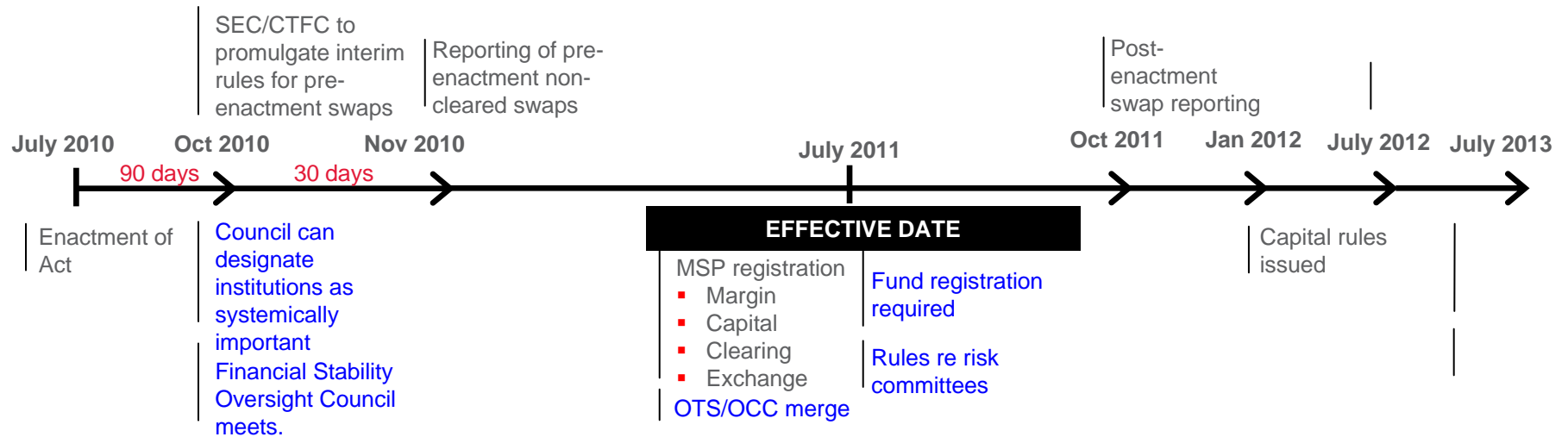
Business Conduct Standards

- CFTC/SEC have broad authority to define and establish new business conduct standards, in addition to what the Act specifies.
- Several new standards are specified in the Act:
 - duty to establish ECP status. Note: reasonable belief in ECP status of counterparty is a protection for dealer, so will be a basic requirement for all documentation. Not really a change, but somewhat more important under new legislation.
 - disclosure duty to counterparty:
 - must cover swap's material risks and characteristics, dealer's material incentives and conflicts of interest and swap's daily marks
 - unclear how risk and conflict disclosure will be made. Can general upfront disclosure suffice (e.g., in ISDA Master) or will more transaction specific disclosure be required?
 - duty to communicate in fair and balanced manner based on good faith and fair dealing

Business Conduct Standards (cont'd)

- Additional standards for dealing with “Special Entities”, which are federal, state, municipal government or agency, certain private or governmental pension plans, and endowments:
 - if swap dealer acts as advisor to Special Entity relating to a swap, then must act in best interests of Special Entity (includes considering financial status, tax status, financial objectives, as well as other factors that may be set by rule).
 - if swap dealer or MSP executes swap with Special Entity, must have reasonable belief that Special Entity is advised by a qualified independent representative.

Studies and Rulemakings



Volcker Rule



Studies and Rulemakings

- The SEC and the CFTC each have published on their websites a planned timeline and have requested comments on various aspects of the required studies and rulemakings
- We have already seen a number of notices or releases and even a few final rules

Investor Protection

Investor protection

- SEC has rulemaking authority to require broker-dealers to provide retail investors with information before the purchase of an investment product
 - SEC has recently spoken about point-of-sale disclosures
- Creates an Investor Advisory Committee within the SEC that will advise on investor protection and disclosure issues
- Investor Advocate would assist retail investors to resolve their problems with the SEC and the SROs

Investor protection (cont'd)

- Standard of care
- Other studies required
 - Research conflicts of interest
 - Financial literacy study
- SEC will be empowered to enact rules to reaffirm or prohibit or impose conditions or limitations on pre-dispute arbitration provisions

Fiduciary duty

- Section 913
 - Required that the SEC undertake a study and issue a report to Congress within six months (issued January 21, 2011) regarding the effectiveness of existing legal and regulatory standards of care for brokers, dealers, investment advisers, and associated persons that provide personalized investment advice to, and recommendations about, securities to retail customers
 - Authorizes the SEC to commence rulemaking based on the findings of its study
 - Empowers the SEC to adopt rules now that:
 - Would require broker-dealers to comply with the standards of conduct applicable to investment advisers when providing personalized investment advice about securities to retail customers
 - Require broker-dealers to notify retail customers and obtain their acknowledgement or consent when the broker-dealer provides only proprietary or a limited range of investment products

Fiduciary duty (cont'd)

- Directs the SEC to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest
- Directs the SEC to promulgate rules prohibiting or restricting sales practices, conflicts of interest and compensation schemes for broker-dealers and investment advisers that the SEC deems contrary to the public interest and the protection of investors
- Amends the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to provide the SEC with authority to bring enforcement actions against broker-dealers or investment advisers in respect of personalized investment advice provided to retail customers

Fiduciary Duty and SEC Study

- Concludes SEC should establish a uniform fiduciary standard for broker-dealers and investment advisers when providing
 - Fiduciary standard no less stringent than that for advisers
 - Duty of loyalty, duty of care
- Study is short on details, but principal conclusion is that the SEC should establish a uniform fiduciary standard for broker-dealers and investment advisers when providing personalized investment advice to retail customers

Fiduciary Duty and SEC Study

- Under this standard:
 - Both broker-dealers and investment advisers must act in the best interest of their customers.
 - In doing so, they must act without regard for their own financial interest.
 - Broker-dealers would be held to a fiduciary standard no less stringent than the existing fiduciary standard for investment advisers under Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 (the “Advisers Act”).
- The Study contemplates that the uniform fiduciary standard would involve both a duty of loyalty and a duty of care. Under the duty of loyalty, a broker or adviser would be prohibited from putting its interests ahead of the customer and would be required to disclose any conflicts of interest. Under the duty of care, a broker or adviser would be held to minimum standards of review and analysis when making investment recommendations or otherwise providing personalized investment advice to retail customers. It is not clear how, if at all, the proposed duty of care would differ from the suitability requirements already imposed on broker-dealers.

Accredited investor standard

- Natural persons with income in each of the two most recent years in excess of \$200,000 (\$300,000 for a couple), or with a net worth of \$1 million either individually or jointly with spouse
 - Requires SEC to exclude from net worth threshold the value of the person's primary residence
 - Requires SEC to review standard and make adjustments (in light of economy) every four years
 - GAO study on criteria for accredited investor status

Family office

- The Dodd-Frank Act subjects more advisers to registration; however, the Act required that the SEC define “family office” for purposes of exempting family offices from the Advisers Act
- The SEC had previously issued several orders exempting family offices from registration but there was no uniform definition
- The proposed rule would define a family office as a firm that provides investment advice only to family members, charities and trusts created by family members and that does not hold itself out as an investment adviser
- Important to watch this process in connection with updating investor rep letters and other forms

Other regulatory/compliance issues

- FINRA actions (H&R block, Ferris Baker)
- FINRA arbitrations (principally involving Lehman notes)
- New task forces at the SEC and at FINRA
- Focus by state securities regulators (for example, New Jersey, New Hampshire, Utah)
- “Ongoing” compliance issues to watch out for in the area, including
 - Adequacy of disclosure
 - Relationships with distributors
 - Misselling/education and training
 - Note reopenings (“taps”)
 - Blackout issues/window cleaning
 - “Freezer” accounts

Regulatory Developments in the EU

Overview of EU Proposals

- EU Regulatory Proposals relating to Retail Investment Products:
 - PRIPs
 - KIID/KII
 - MiFID Review
- Prospectus Directive amendments
- FSA – Retail Distribution Review and TCF
- AIFM Directive

PRIPs

- Packaged Retail Investment Products (PRIPs):
 - Investment funds
 - Structured securities
 - Some life insurance policies
 - Structured term deposits
- Investor protection
- Level playing field

History

- ECOFIN Council Request – May 2007
- European Commission Call for Evidence – October 2007
- EU Commission Communication – April 2009
- EU Commission Technical Workshop – October 2009
- EU Commission PRIPs Progress Update – December 2009
- Report of the 3L3 Task Force on PRIPs – October 2010
- EU Commission further Consultation on PRIPs – 26 November 2010
- EU Commission MiFID Review Consultation – 8 December 2010

Scope of PRIPs

- Commission acknowledges difficulty of establishing a clear definition of a PRIP but considers objectives should be to
 - Encompass key packaged investment products currently being marketed in the EU
 - Be flexible enough to cover new products as they develop
 - Avoid incentivising regulatory arbitrage
 - Provide sufficient legal certainty as to the products covered

Packaging/Investment Risk

- Commission believes key characteristics of PRIPs is that they are
 - “Manufactured” by a firm
 - Packaging different assets or elements of an investment together through
 - (i) wrapping a financial asset within another structure (e.g. UCITS or structured note, or
 - (ii) providing investment management through a collective investment scheme, or
 - (iii) devising a financial instrument creating exposure to other instruments, indices or reference values

Proposed Definition of PRIPs

- “A product where the amount payable to the investor is exposed to fluctuations in the market value of assets or payouts from assets, through a combination or wrapping of those assets, or other mechanisms than a direct holding”
- Consideration of “white list” of PRIPs
- Definition does not embed retail element but it is intended that disclosure and selling rules should only apply to sales to retail investors

Inclusions in PRIPs Definition

- In previously considering the possibility of coming up with a “white list”, the 3L3 Task Force unanimously concluded that the following products should be included:
 - Structured products (including structured deposits)
 - Investment funds (UCITS and non-UCITS)
 - Unit linked and index-linked life insurance
 - Warrants (including covered warrants) and convertible bonds
 - Asset-backed securities
 - Capital redemption operations linked to unit-linked investment funds

Exclusions from PRIPs Definition

- Exclusions from definition
 - Plain vanilla bank deposits
 - Simple life assurance policies/pure protection insurance
 - Plain vanilla corporate shares/bonds (including subordinated bonds)
 - Non-financial spread bets.
- Further clarity needed in following areas:
 - What deposits will constitute structured deposits?
 - Pensions (to be excluded from PRIPs regime at present?)

PRIPs – Disclosure Requirements

- EU Commission proposes development of new disclosure framework applicable to PRIPs generally – “Key investor disclosure”
- UCITS “KII” regarded as benchmark
- Objective is harmonisation and standardisation of key disclosures:
 - Allowing for comparison between products
 - Some tailoring permitted
- Issue as to whether KIID should be a document separate from any other prospectus or background document

PRIPs – Disclosure Requirements – Key Principles

- Product disclosures should be fair, clear and not misleading
- Disclosure should be comprehensible to target investors and be short and simple (but contain all key information)
- Information necessary to take an informed investment decision should be included
- So far as possible, disclosures should promote comparisons between different products
- Disclosure should be provided in a timely fashion to investors
- Associated marketing communications should be fair, clear and not misleading

PRIPs – Disclosure Requirements – Issues for further consideration

- Risk considerations – inclusions of simple risk indicator?
- Costs – aim is to enable easy comparison between different products
- Approach in relation to information on performance
- Information to enable comparability between guarantees or capital protection for PRIPs
- Responsibility for KIID preparation – likely to be product manufacturer in most cases
- Obligation to update KIID?

PRIPs – Disclosure Requirements – Types of PRIPs

- JAC identified two broad categories of PRIPs:
 - Contractual PRIPs
 - Collective investment PRIPs
- Features differ between such products, meaning there should be a different approach in the KIID for each

Disclosure Requirements – Development of KIID Template

- Significant work done in developing KII document for UCITS
 - CESR consultation papers in July 2010
 - Draft template published
- UCITS regime is very prescriptive
- JAC submissions
- JAC pro forma template KIID

Disclosure Requirements – JAC KIID Template

- Purpose section
- Quick facts
- Product description
- Key risks
- Charges and taxes
- Further information available
- How to purchase product and whom to contact for further information
- Details of product producer and product distributor
- Annexes including scenario analysis/historical performance and information on underlying

PRIPs – Selling Practices

- Key elements identified by the Commission are:
 - Conduct of business rules
 - Inducements
 - Conflicts of interest
- MiFID regarded as benchmark
- MiFID will already apply to many PRIPs but doesn't currently catch:
 - Insurance products
 - Structured deposits

PRIPs Selling Practices – Key Principles Identified by Commission

- Selling practices should be focused on fair treatment of the investor
- Advised sales – the advisor must undertake steps to ensure the product is consistent with investor needs and investor understands the product
- Non-advised sales – there must be clear communication of the limits to the service provided and risks to the investor
- Conflicts of interest should be avoided or properly managed and disclosed
- Clear and effective disclosure of fees, charges and commission
- Those assessing suitability of products must fully understand them

PRIPs – Selling Practices – Advised v Non-advised Sales

- MiFID currently requires all products sold on an advised basis to be subject to a suitability test
- MiFID does not currently catch certain products such as life policies and structured deposits
- For non-advised sales on an execution basis only, an appropriateness assessment (relating to knowledge and experience) may be required but Article 19(6) of MiFID provides an exemption for certain products including:
 - Shares admitted to trading on a regulated market
 - Bonds or other forms of securitised debt which do not embed a derivative
 - UCITS
 - Other non-complex financial instruments (in accordance with Article 38 of the level 2 MiFID Directive)

PRIPs – Selling Practices – MiFID Review

- EU MiFID Review Consultation – 8 December 2010
- Conduct of business and conflicts of interest rules to be extended to:
 - Advised and non-advised sales of structured deposits
 - Firms selling their own securities even on a non-advised basis
- Client classifications largely unchanged
- Insurance Mediation Direction (IMD) will be amended to bring conduct of business and conflicts of interest rules in line with MiFID

PRIPs – Selling Practices – MiFID Review Complex v Non-complex products

- Two possible options outlined
 - Option 1:
 - Minor adjustments to Article 19(6)
 - Certain structured UCITS may cease to be automatically non-complex
 - Option 2:
 - Abolition of execution-only exemption
 - Appropriateness test will then always be needed for non-advised financial services to retail investors

Prospectus Directive Amendments

- Prospectus Directive applies to public offers of securities in the EU subject to certain exemptions
- Amendments to the PD came into force on 31 December 2010
- Member states must implement changes by 1 July 2012
- Some amendments to PD exemptions:
 - Minimum denomination exemption increased from €50,000 to €100,000
 - The number of persons exemption is increased from 100 to 150 persons
- Summary section of prospectus to include “key information”
- Retail cascades – no new prospectus is needed in subsequent resale subject to issuer consent

UK FSA – Retail Distribution Review

- Comes into force on 1 January 2013
- Changes include:
 - Additional requirements for independent financial advisers (IFAs) to term themselves “independent”
 - Independent advisers must offer the ‘whole of the market’ and provide unbiased, unrestricted advice
 - Independent advice should be based on an analysis that is comprehensive and fair relative to what the client requires
 - All adviser firms will have to agree fees upfront with the client
- RDR will be under the control of the Bank of England

UK FSA – Treating Customers Fairly

- TCF has been an ongoing initiative of the FSA
- Review in relation to structured investment products following Lehmans collapse
- October 2009 paper set out various recommendations including:
 - Providers and distributors should consider the impact of their actions on the customer during the life cycle of the product
 - Continuous assessment of the various risks before and after sale and alerting customers if action needs to be taken
 - All relevant risks be adequately identified and stress tested
 - Products should be suitable for target audience
 - Providers should act with due diligence in passing on promotions they have created to distributors

AIFM Directive

- Approved by EU Parliament on 11 November 2010
- To be implemented by all EEA member states two years after publication in OJ (which is expected in first quarter of 2011)
- Many implementing measures yet to be drafted
- Will apply to:
 - All EU alternative investment fund managers (AIFMs) managing any AIF
 - All non-EU AIFMs managing an EU AIF or marketing any AIF in the EU
- A fund manager regulated by its home member state is exempt if its assets under management do not exceed €100m
- AIFMs must be authorised before they can provide management services to EU or non-EU AIFs unless an exemption applies

AIFM Directive (cont.)

- Additional capital and operational requirements
- Transparency and disclosure requirements
- EU AIFMs will be able to market EU AIFs to professional investors across the EU under a marketing passport
- Subject to notification and certain conditions, from 2015 the passport is extended to EU AIFMs marketing non-EU AIFs across the EU
- From 2015, a non-EU AIFM can obtain a marketing passport and enjoy the same market access as an EU AIFM:
 - Must obtain prior authorisation from competent authority of 'member state of reference'
 - Other conditions must be satisfied
- From 2018, non-EU AIFMs may continue to make use of national private placement regimes, provided that certain minimum conditions are satisfied

Common Themes

Common themes

- Focus on investor protection
- In the EU, PRIPs and other initiatives seek to reduce ability for regulatory arbitrage
- We anticipate continuing regulatory scrutiny and additional enforcement actions or investigations
- Costs of doing business will rise
 - In the US, we anticipate that Dodd-Frank will have numerous ripple effects for the business (Section 23A/B changes), OTC derivatives changes, etc.
 - Addressing regulatory inquiries