

Structured Thoughts

News for the financial services community.



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Is Bigger Better? Or Do Good Things Come in Small Packages?

Over time, the suite of disclosure documents for securities offerings has grown longer and longer. Prospectuses, prospectus supplements and product supplements for structured notes are no exception.

A variety of factors combine to explain the phenomenon. In no particular order:

- Modern PC technology makes cutting and pasting a breeze.
- Market participants have attempted to keep their documents in line with the most recent guidance (and warnings) from the SEC and FINRA.
- Many market participants are engaged in a bit of a “risk factor arms race.” Many people can feel a bit uneasy if they see a competitor adding a new risk factor that they haven’t yet added.

And last but not least:

- Many market participants are striving to improve their documents. That process often concludes with the addition of new disclosures or explanations.

There are currently pressures in the market that cut in different directions—in some ways, encouraging issuers to use longer disclosure documents; in other ways, to use shorter, more focused disclosure documents.

Let's look (perhaps a bit unscientifically) at the SEC's April 2012 sweep letter.¹ Of the 14 numbered comments in the letter, 10 seem to tend towards additional disclosures.² One comment,³ relating to the format of offering documents, could be construed as a request to provide shorter, more tailored, disclosure documents.

In contrast, note the following quote from Richard Ketchum at FINRA's May 2012 annual conference: "before any complex product is offered to a retail client, your financial adviser should be able to write down on a single page why this investment is in the best interests of your client."⁴ Market participants strive to make their documents easily understood by retail investors, and that often means that brevity and simplicity are critical features. And, of course, European market participants are working on preparing forms of "KIIDs," ("key investors information disclosures"), which are designed to summarize the key terms of retail structured products in a readily digestible size.⁵

The trick, of course, is ensuring that all material information is conveyed, while helping to ensure that the information provided will actually be useful, easily accessible and read by investors.

Proposed SEC Regulations under the JOBS Act Increases Options for Private Structured Notes Program

Introduction

In August 2012, the SEC released its long-awaited proposed rules under the JOBS Act. The proposed rules would, subject to several limitations, enable issuers and underwriters to effect a general solicitation in connection with offerings under Regulation D and Rule 144A, provided that the relevant securities are sold only to accredited investors or qualified institutional buyers ("QIBs"), as applicable.

The SEC's proposing release may be found at the following link on the SEC website:

<http://www.sec.gov/rules/proposed.shtml>. For our firm's summary of the new rules, please see our client alert, "Solicitation Emancipation," which may be found at the following link:

<http://www.mofo.com/files/Uploads/Images/120829-Solicitation-Emancipation.pdf>.

Removal of Restriction on General Solicitation

If adopted in their present form, the new rules would open up a variety of potential offering opportunities for issuers and underwriters of structured notes issued pursuant to exempt continuous offering programs. For example, these programs could utilize unrestricted websites in order to publicize their existence and the securities that they offer. Such websites could also post the offering documents for current and completed offerings.

Under current rules, publicity of this kind would render the programs and offerings unable to take advantage of the relevant private placement exemptions. As a result, issuers and underwriters engage in very limited publicity relating to these programs, and any websites that relate to these programs are typically accessible only on a password-protected basis.

¹ Available at the following link: <http://www.sec.gov/divisions/corpfin/guidance/structurednote0412.htm>.

² Comments 1-5, 6, 8-10 and 14.

³ Comment 13.

⁴ Available at <http://www.finra.org/Newsroom/Speeches/Ketchum/P126481>.

⁵ See "Worth the Wait? Draft PRIPs Legislation Finally Published," in our July 20, 2012 issue of "Structured Thoughts" (<http://www.mofo.com/files/Uploads/Images/120720-Structured-Thoughts.pdf>).

Rule 144A and Regulation D programs would be the principal beneficiaries of these new features. In addition, private bank note programs operated by national banks under Part 16.6 of the OCC's securities offering rules, which incorporate the provisions of Regulation D and Rule 144A, could also benefit from the new rules.⁶

Adoption of New Practices?

With respect to Regulation D offerings, new Rule 506(c)(2)(ii) would require the issuer to take reasonable steps to verify that purchasers of the securities are in fact accredited investors.⁷ In the proposing release, the SEC indicated that the manner in which the securities are offered will affect the determination of whether the steps are reasonable—the more broadly the securities are marketed, the more exacting the required steps. Broker-dealers who have an existing relationship with investors, and access to their financial information, may frequently be in a good position to reach a conclusion as to a potential investor's accredited investor status. However, if a website is used to solicit new investors in a Regulation D offering, the issuer and any broker-dealer should proceed with an increased degree of caution in establishing the accredited status of the new investors.

The Rule 144A market for structured notes has historically functioned without significant use of websites as a means of disseminating offering information. However, the new rules would present issuers and underwriters with an additional means of soliciting interest among institutional investors, and of communicating potential offering terms.

Comment Period

The new rules are subject to a 30-day comment period. This period is shorter than the typical SEC comment period, primarily due to the fact that these new rules were required to be adopted by the JOBS Act. After the SEC has the opportunity to review the comments, final rules are expected to be adopted. These rules are likely to enable broader publicity of private structured note programs than the U.S. market has previously seen. The market will then have the chance to observe whether participants attempt to capitalize on these rules in connection with private structured note programs.

“Is Our Children Learning?” Not about Financial Investments

The SEC's recent study on financial literacy asks whether retail investors are learning about, and knowledgeable about, financial products and services. At the end of August, the SEC's Office of Investor Education and Advocacy issued a study required by Section 917 of the Dodd-Frank Act regarding financial literacy among investors, which is available here: <http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf>. The study draws from a Library of Congress report on financial literacy among retail investors. Although the study focuses on disclosures in the context of mutual funds, many of the observations made in the study are likely to inform the views of regulators as they consider the adequacy and presentation of offering materials related to other types of securities offerings. As a general matter, the study concludes that retail investors in the United States lack basic financial literacy. The study had as its objectives seeking to identify methods to improve the timing, content, and format of disclosures to investors with respect to investment products and seeking to understand the type of information that is most helpful to investors.

Not surprisingly, the study finds that retail investors prefer to receive disclosures prior to making their investment decision about a financial product or a service. In terms of the content of disclosures, the study finds that investors identify the following information as the most important or useful to them: information about investment objectives and strategy, past investment performance, fees, expenses, conflicts of interest and principal risks. Investors strongly prefer to be presented with information in the form of graphs, tables, bullet points and charts. For those of us in the structured products market, this is useful information. Surprisingly, investors prefer that information be presented using a “layered” approach. From time to time, regulators considering structured products disclosure

⁶ See 12 C.F.R. 16.5(e) as to Rule 144A, and 12 C.F.R. 16.7 as to Regulation D.

⁷ This requirement is similar in some respects to existing Rule 144A's requirements with request to QIBs.

have expressed concerns regarding the layered approach of base prospectus, prospectus supplement or product supplement, pricing supplement and term sheet that is common to this market. Some comfort can be taken from the reactions of retail investors consulted during the financial literacy study. Of course, retail investors prefer that disclosures be written in plain English. The study also points to the need for more transparent disclosure of fees, including a narrative discussion, as well as a table or bulleted presentation, or examples illustrating fee calculations. Similarly, the study stresses the need for more robust and transparent disclosures regarding conflicts of interest.

“Plain English” Ends ProShares’ ETF Class Action

In September 2012, a federal district court dismissed a class action lawsuit against 44 ProShares exchange traded funds (“ETFs”) and their investment adviser, officers and trustees. The ProShares ETFs at issue were inverse ETFs, ultra long ETFs and ultra short ETFs that were designed to track the underlying indices for periods of one day or less. According to the registration statements, the ETFs’ value could “diverge significantly” from the underlying index if held for longer than this short period of time.⁸ Investors filed suit under Sections 11 and 15 of the Securities Act of 1933, claiming that the prospectuses failed to adequately disclose the risks relating to the funds’ potential to lose value.

Referencing the registration statements’ “plain English,” the court determined that “the disclosures...accurately conveyed the specific risks that the plaintiffs assert materialized.”⁹ The court then granted ProShares’ motion to dismiss in its entirety.

To read more about the ProShares class action and how well-crafted risk factors can reduce the potential for liability, please see our related [client alert](#).

Contacts

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

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

Ryan Williams
(212) 336-4227
ryanwilliams@mofo.com

For capital markets focused twitterings, follow us [@thinkingcapmkts](#).

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>.

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⁸ Registration Statement for ProShares Trust dated July 6, 2012, available at http://www.sec.gov/Archives/edgar/data/1174610/000119312512296206/d310894d485bpos.htm#toc310894_2.

⁹ *In re Proshares Trust Sec. Litig.*, 2012 U.S. Dist. LEXIS 128542, *30 (S.D.N.Y. Sept. 7, 2012).