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Structured Thoughts

News for the financial services community.

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The SEC Issues Its Long-Awaited Sweep Letter on ETNs

On February 11, 2014, the SEC's Division of Corporation Finance sent a "sweep" letter to exchange-traded note (ETN) issuers. The letter contains 14 items, some of which have application to all structured products, not just ETNs. The letter is the first significant SEC statement about ETNs since the SEC's Division of Market Regulation issued two Regulation M no-action letters in 2006 and 2007.[1]

ETNs are inherently more complex, and more difficult to describe simply, than a typical structured note. Due to the effect of the annual fee, and the redemption and call features, the payoff profile of an ETN is difficult to describe succinctly in the up, flat and down scenarios descriptive of many non-ETN structured notes. Consequently, prospectus descriptions of ETNs are often lengthy and use multiple defined terms. Some of the items in the sweep letter address these disclosure issues.

Terms of the Offering

For example, Item 1 of the sweep letter asks issuers to "revise your prospectus supplements, as appropriate, to disclose the material terms of each ETN in a clear, concise and understandable manner," citing the SEC's plain-English disclosure requirements.

[1] Barclays Bank PLC, Staff No-Action Letter (July 27, 2006) (the "iPath Letter") and Deutsche Bank AG, Staff No-Action Letter (October 12, 2007).

Item 6 of the sweep letter requests clear disclosure of the redemption value of an ETN. The SEC asks issuers to disclose whether the redemption value is publicly available prior to an investor's redemption. ETN issuers normally disclose in the prospectus supplement that there is a one-day delay during which a redeeming investor is at risk due to the time period between the investor's submission of a properly executed redemption request and the calculation of the actual redemption price on the trading day following receipt of the request. Generally, a related risk factor is also included.

Item 7 of the sweep letter relates to disclosure of any applicable fees that may be charged relating to the ETNs. This item mentions index calculation fees, in addition to the normal ETN-related charges, such as annual fees and redemption charges. The Item requests disclosure of the party responsible for payment of each fee, how the fees may change based on the performance of the underlying asset, when the fees are collected and their effect on the redemption amount and the intraday indicative value. Issuers of any structured notes linked to an index (whether or not in ETN form) for which fees are deducted when calculating the index level may consider this guidance related to fee disclosure and, to the extent possible, add an explanation of their effect on the index level and payout at maturity.

Item 2 of the sweep letter requires revisions to prospectus supplements that do not disclose that the issuer may cease or suspend and restart sales of ETNs any time at the issuer's discretion. This item also requests clear disclosure of the effect of any such actions on liquidity in the secondary market and the addition of appropriate risk factors, if the issuer views such discretion as material.

This comment seems to be a response by the SEC to a few cases where ETNs began to trade away from the value of the underlying reference asset, due to shortages of those ETNs caused by various issuer actions. Due to these types of events, most ETN prospectuses contain clear disclosure of any internal position limits that may cause the issuer to cease ETN issuances and the resulting potential price distortions between the trading value of the ETNs and the value of the underlying asset, as reflected in the indicative value. ETN issuers generally disclose that they may not sell the full principal amount of the ETNs listed on the cover of the prospectus supplement, and may suspend and resume sales of the ETNs at any time, with appropriate risk factor disclosure relating to the effect of those actions on trading prices. Issuers should be wary of suspending and resuming ETN issuances, even for good reasons, as the optics may be negative.

Indicative Value

Issuers of ETNs are regularly "creating," or issuing, new ETNs, and reselling ETNs that have been previously redeemed or repurchased by the issuer's affiliated broker-dealer. Due to the ongoing creations, the "distribution" of the ETNs, for purposes of Regulation M, does not end until the ETN is called or matures. The affiliated broker-dealers of ETN issuers engage in market-making activities in the ETNs, constantly purchasing and selling ETNs in the market. Normally, redemptions by the issuer and market-making bids and purchases by the affiliated broker-dealer would raise questions under Regulation M.

In order to address these Regulation M issues, in 2006, Barclays Bank plc received the iPath Letter from the SEC's Division of Market Regulation, under which the SEC staff granted relief from Rules 102 and 101 for the redemption of ETNs by the issuer and the market-making activities of its affiliated broker-dealer. In the iPath Letter, the staff agreed that the availability of real-time pricing information for both the ETNs (due to their NYSE listing) and the underlying reference asset (index levels are publicly available in real time), plus the ability of arbitrageurs to redeem ETNs and purchase new ETNs, would prevent any significant differences between the price of the ETNs and the underlying reference asset.

One of the items of trading information on the iPath ETNs that counsel argued was relevant for reference purposes, and the staff did not disagree, was Barclays' real-time publication of the ETNs' intraday indicative value, which is intended to be an approximation of the value of the ETNs and is derived under a formula included in the prospectus supplement. The intraday indicative value is one more piece of information for investors to use to compare against the actual market value of the ETN on the NYSE and the level of the underlying asset when determining whether to hold, redeem or purchase ETNs.

Item 3 of the sweep letter asks issuers to explain the purpose of calculating the indicative value and why it is relevant to investors. The sweep letter requests that issuers avoid presenting the indicative value as a formula, and instead use clear, narrative disclosure.

Item 5 requests that, if the indicative value is included in the prospectus supplement, there be a clear explanation of the differences between the indicative value, "the market value of the ETN relative to the initial price to public" and the redemption amount. A relevant risk factor should also be included. Under the iPath Letter, an issuer must include the indicative value. The redemption amount is typically the indicative value minus the stated redemption fee. Most issuers include robust disclosure about the differences between the different value measures and risk factors, disclosing that the trading prices, and the amount that an investor would receive upon redemption or call, may vary substantially from the indicative value.

Requesting disclosure of the market value of the ETNs *relative to the initial price to public* seems to call for estimated initial value-type disclosure for ETNs. In the sweep letter's introduction, reference is made to the April 2012 sweep letter "for additional disclosure matters that may be applicable to ETN offerings." The most significant item in the April 2012 sweep letter was the requirement that issuers include their estimated initial value of their structured products in prospectuses. ETNs, as opposed to unlisted structured products, immediately start trading at their actual resale value on the NYSE. Due to, among other things, the liquidity of ETNs and the easy availability of their actual resale value, ETN issuers have not included estimated initial value in their prospectus supplements.

Regulation M

Item 14 of the sweep letter focuses, once again, on ETN price distortions due to a suspension of issuances or a lack of supply (see Item 2 above). In this item, the SEC specifically points to the iPath Letter and the Deutsche Bank no-action letter and requests an explanation of how an issuer's purchase of an ETN in response to a holder's redemption request during a period of price distortion would be in compliance with the Regulation M relief granted in those no-action letters. If an issuer suspends issuance of ETNs, the distribution, for purposes of Regulation M, would be completed, and a redemption of an ETN by the issuer would not violate Regulation M.

Short Sales

In Item 13 of the sweep letter, the SEC requests that issuers disclose short sale activities by broker-dealers and others and how the loans and repurchases will be disclosed, and a confirmation that the issuer will register these transactions under the Securities Act of 1933. Appropriate risk factor disclosure is also requested describing the market effect that short sales and securities lending activities may have on ETN liquidity.

ETN prospectuses normally disclose that dealers (including affiliates of the issuer) may resell an ETN acquired from a holder in a market-making purchase, or pursuant to a redemption, and that they may sell an ETN in covering a short sale transaction. The prospectus will also disclose that it will be deemed to cover any short sales of ETNs by market participants who cover their short position with ETNs borrowed from the issuer or its affiliates.

In the iPath Letter, counsel stated that there would be short sales of ETNs by dealers and exchange specialists to satisfy customer demand. Relief was requested, and received, from two short sale rules, old Rule 10a-1 under the Securities Exchange Act of 1934 ("Exchange Act") and Rule 200(g) of Regulation SHO under the Exchange Act.

Multi-Tranche Prospectuses

The SEC also questions the practice of using a single prospectus supplement to offer multiple ETNs with different investment profiles. Some ETN issuers will include long and short versions of an ETN with the same underlying asset on one prospectus, or multiple ETNs with different underlying assets on one prospectus. Item 11 of the sweep letter asked issuers to explain why they believe that practices like these are appropriate. Of course, many structured note issuers include multiple notes with the same payoff structure, but different underlying assets of the same type, on one prospectus supplement.

Websites

In Item 9 of the sweep letter, the SEC requests disclosure of the number and dollar amount of outstanding ETNs in a series. Most ETN issuers maintain websites on which they publish that information. Their prospectus supplements should make reference to those websites.

Familiar Issues

The sweep letter also calls on issuers to consider other disclosure items that have been previously raised by the SEC:

- Disclosing activities that create conflicts of interest between the issuer and its affiliates and ETN purchasers, and the impact of those activities on supply, pricing and the market for ETNs (Item 8);[2]
- Avoiding security titles that suggest that investors are purchasing anything other than an unsecured debt obligation—use of the word "shares" should be avoided, as should any suggestion that the ETNs are interests in an exchange-traded fund (Item 12); and
- A reminder to comply with Item 508 of Regulation S-K by clearly disclosing the roles of broker-dealers in sales of ETNs. The staff also requests information as to how these broker-dealers satisfy their prospectus delivery obligations for these offerings.

Responses

The SEC requests that issuers respond to the sweep letter within 10 business days (February 27, 2014). It is possible that these response letters will be available on the SEC's website.

Conclusion

Many of the sweep letter's items reflect the SEC's ongoing concerns about clear disclosure to investors, particularly in the area of complex products. Most active ETN issuers' prospectus supplements contain disclosure that is in substantial compliance with the concerns raised by the SEC in the sweep letter.

FINRA Proposes Amendments to Communication Rules – Relief from Filing for Certain FWPs

On March 10, 2014, FINRA filed with the SEC proposed amendments to its communication rules.[3] Among other items, the proposal relates to the filing and content requirements for retail communications relating to structured products.[4]

Filing Requirements

Rule 2210, as amended effective February 2013, requires broker-dealers to file with FINRA "retail communications" concerning registered structured products. Rule 2210(c)(7)(F) exempted from this requirement prospectuses, preliminary prospectuses, offering circulars and similar documents that are filed by the issuer with the SEC.

Many market participants found Rule 2210's filing requirements somewhat ambiguous as to the filing requirements for free writing prospectuses (FWPs) that are exempt from filing with the SEC under Rule 433. The most widely used of these types of documents are preliminary (or summary) "term sheets," which are often provided to investors along with the longer red herring; these documents were typically not filed with the SEC, due to Rule 433(d)(5)(i). Since they were not filed with the SEC, they appeared to require filing with FINRA under the text of the rule. As a result, many brokers began to file these types of documents with FINRA; alternatively, a variety of issuers began to file them with the SEC,

[2] For a discussion of FINRA's recent focus on dealer conflicts of interest relating to structured products, see Volume 4, Issue 13 of Structured Thoughts (October 15, 2013), available at: http://www.mofo.com/files/Uploads/Images/131015-Structured-Thoughts.pdf. FINRA's Report on Conflicts of Interest is available at: http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf.
[3] The proposed rules may be found at the following link: https://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p458589.pdf.
[4] The proposed rules would also exclude from the filing requirements research reports that relate only to securities listed on a national securities exchange. The proposal would also address a mistaken cross-reference in FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools).

notwithstanding the exemption from Rule 433's filing requirement, in order to benefit from the exemption from FINRA filing under Rule 2210(c)(7)(F).

In the proposed rule amendments, FINRA indicated that it intended the exclusions from its filing requirements to cover both prospectuses filed with the SEC **and** FWPs that are exempt from filing. However, the rules will continue to require broker-dealers to file FWPs with FINRA that are filed with the SEC under Rule 433(d)(1)(ii)—this provision applies to underwriter FWPs that are made available on a broad unrestricted basis, such as a website.

Content Requirements

In addition, the proposed amendment clarifies that an FWP that is exempt from filing with the SEC under Rule 433 is not subject to FINRA's content standards. However, we do not expect FWP disclosures to change significantly as a result of this clarification. These documents, if they contain material misstatements or omissions, can still result in liability under the federal securities laws. Accordingly, market participants will continue to carefully review their content, and whether they are appropriate for the target audience.

FINRA Review

At an appearance in a December 2013 conference, FINRA representatives noted that, as a result of the Rule 2210 filing requirements, it had received more than 800 communications for review.[5] FINRA indicated that it had issued comments on approximately 80% of these filings. Many of these were preliminary term sheets, filed with FINRA due to the uncertainties noted above. (Many of these filings also may have been somewhat repetitive, as they could relate to similar offerings that were made on a weekly or monthly basis.) As a result of the FINRA comment process, many market participants have had an opportunity to learn more about FINRA's views as to structured product disclosures, and to make a variety of revisions to their documents to address these views.

Effective Date

FINRA indicated in its proposal that, if the SEC approves the proposals, FINRA will announce the effective date in a Regulatory Notice published within 60 days of the approval. The effective date will be no later than 30 days after that Regulatory Notice.

Comprehensive Surveillance Sharing Agreements

From time to time, market participants need to consider whether a "comprehensive surveillance sharing agreement" is in effect between a U.S. securities exchange and a non-U.S. securities exchange. This article seeks to help demystify what these are, why they can be important and how they can be found.

When These Agreements Come Into Play

There are a number of contexts in which these agreements are relevant to the SEC's rules, or to relevant stock exchange rules. For example, the SEC relies on these agreements in evaluating exchange rule changes to allow trading in new derivative products that are based on foreign securities or indexes, such as in the case of listed options on an ADR. In such a case, the SEC will want to know that there is a surveillance agreement in effect between the applicable U.S. exchange and the primary non-U.S. exchange for the securities that underlie the ADRs. Under Section 19(b) of the Exchange Act, U.S. exchanges are required to submit proposed rules and rule changes to the SEC for approval, including rules that would allow trading in new derivative products that would not be covered by existing listing standards. In order to approve a proposed rule, the SEC must find that, among other things, the rule is consistent with Section 6 of the

[5] "SEC and FINRA Personnel Speak at Structured Products Conference", Structured Thoughts, Volume 5, Issue 1 (January 2014), available at: http://www.mofo.com/files/Uploads/Images/140107-Structured-Thoughts.pdf.

Exchange Act, which requires an exchange to have the capacity to enforce compliance with its rules and the securities laws, and to enact rules designed to prevent fraud and manipulation. In making this finding regarding a request for approval of U.S. derivative products based on non-U.S. securities or indexes, one factor that the SEC evaluates is whether the U.S. exchange sponsoring the product has entered into surveillance agreements with the relevant foreign markets.

The issue also arises when an issuer of a structured note attempts to determine whether it can issue a stock-linked note that is linked to a particular non-U.S. equity security, under the "Morgan Stanley letter." In addition to the "S-3/F-3 primary eligibility" test under the Morgan Stanley letter, the letter also provides for the possibility of linking to common equity securities where those securities would be eligible for listing on a national securities exchange under that exchange's rules. The provisions of the relevant rules, such as NYSE Rule 703.21(C)(b)(i), require that the exchange have a comprehensive surveillance sharing agreement with the principal non-U.S. exchange for that security.

What Is a Comprehensive Surveillance Agreement?

A surveillance agreement provides that a non-U.S. entity will be able to produce and share relevant information about market trading activity, clearing activity and customer identity, without being materially impeded by the non-U.S. entity's rules, or secrecy or blocking laws. The SEC has identified the key criteria of such an agreement as the inclusion of provisions as to each of these types of information, and that the party to the agreement has the ability to obtain and produce this information. The SEC must determine that, based on the agreement and any other relevant information provided by the non-U.S. party, existing rules, laws, or practices would not impede the U.S. entity from obtaining the relevant information.

Does Such an Agreement Exist?

Absence of a List. Unfortunately, there is no single source of publicly available information that can be used to determine whether an appropriate agreement exists between the relevant U.S. securities exchange on the one hand, and the non-U.S. securities exchange on the other hand. These are privately negotiated agreements, and cannot be found on any public database. Accordingly, a phone call to the legal department of the relevant U.S. securities exchange may be needed to determine whether the agreement exists.

The ISG. However, since 1994, the SEC has taken the position that a non-U.S. exchange's affiliate membership in the Intermarket Surveillance Group (ISG) will serve to denote the existence of a comprehensive surveillance agreement. The SEC has had the opportunity to review the documentation and agreements used by the ISG to accept affiliate members, and determined that process to be sufficient.

The ISG was established in the 1980s, and includes an international group of exchanges, market centers and market regulators that perform market surveillance in their respective jurisdictions. The ISG coordinates and develops programs and procedures to identify possible fraudulent and manipulative activities across markets, and shares necessary information among members. In the U.S., the ISG's membership includes, for example, the NYSE and Nasdaq. A list of the ISG's non-U.S. members is available on its website (https://www.isgportal.org/isgPortal/public/members.htm), and includes a variety of securities exchanges in the Americas, Asia and Europe on which a variety of U.S.-traded common equity securities have their primary listings. Accordingly, the website can be a useful resource for evaluating a proposed instrument, and whether it will satisfy the relevant rules.

FINRA Provides a Detailed Analysis of a Broker-Dealer's Failure to Adequately Supervise Alternative Investment Sales

In March 2014, the Financial Industry Regulatory Authority fined a broker-dealer for supervisory deficiencies related to its failure to adequately supervise the sale of "alternative investments." These investments include a laundry list of products that have been at the forefront of FINRA's priorities in recent years: non-traded real estate investment trusts, oil and gas partnerships, business development companies, hedge funds, managed futures and other illiquid pass-through investments.

FINRA's findings provide a useful "case study" as to the types of issues that a firm should consider in evaluating its own processes for sales of complex products, including structured products.

Our client alert as to these findings may be found at the following link: http://www.mofo.com/files/Uploads/Images/140327-FINRA-Provides-a-Detailed-Analysis.pdf.

Final Rule Imposing Enhanced Prudential Standards on Foreign Banking Organizations

In the first quarter of 2014, the Federal Reserve Board issued its long-awaited final enhanced prudential rule (Regulation YY) under Section 165 of the Dodd-Frank Act for bank holding companies and foreign banking organizations (FBOs) with global consolidated assets of $50 billion or more.

The Federal Reserve expects that approximately 100 FBOs will be subject to enhanced prudential standards under the final rule. In addition, the final rule imposes stress testing on FBOs with total consolidated assets of $10 billion or more, and requires the establishment of U.S. risk committees for FBOs with total consolidated assets of $10 billion that are publicly traded. A number of these entities are significant issuers of structured products in the U.S.

Our client alert as to the final rule may be found at the following link: http://www.mofo.com/files/Uploads/Images/140224-Final-Rule-FBO-Standards.pdf.

Contact

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

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

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

For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/Thinkingcapmkts.

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

Morrison & Foerster named Best Law Firm in the Americas, 2012, 2013 by *StructuredRetailProducts.com*.

Morrison & Foerster named Legal Leader, 2013 by *mtn-i* at their Americas Awards. Two of our 2012 transactions were also granted awards of their own as a result of their innovation.

Morrison & Foerster named European Law Firm of the Year, 2013 by *Derivatives Week* at their Global Derivatives Awards.

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