The ETN Sweep Letter
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The Division of Corporation Finance sent a sweep letter to many ETN issuers on February 11, 2014, containing 14 items. The letter is not available on the SEC’s website.

The letter addresses two main areas of concern, disclosure modernization and clearly addressing the potential for price discrepancies between the ETN and the underlying asset.

- Disclosure points:
  - Use plain English in defining terms
  - Clear explanation of the redemption value
  - A full accounting of any applicable fees
  - Whether the issuer may cease or suspend ETN sales at any time, and the resulting effect on trading prices
  - Avoid confusing titles, don’t use the word “shares” or include anything that suggests that the ETNs are actually interests in ETFs
  - Clearly disclose any conflicts of interest between the issuer and its affiliates and the ETN holders
The ETN Sweep Letter (cont’d)

• Indicative value:
  o What is it, and why is it relevant?
  o Avoid formulas, clearly explain the elements of indicative value
  o Explain the relationship between indicative value, trading price and the redemption amount
    • Include risk factor disclosure that the ETN may trade at a substantial premium or discount in relation to the indicative value or the redemption amount
The ETN Sweep Letter (cont’d)

• Regulation M: The SEC asked how redemptions of ETNs during times that there are price distortions due to suspensions of further ETN issuances comply with the iPath no-action letter.
• 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.
  o 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 during the distribution would raise questions under Regulation M.
The ETN Sweep Letter (cont’d)

In 2006, Barclays Bank plc received the iPath no-action 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.

• 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.

• If an issuer stops issuing ETNs, then the Regulation M distribution period ends, and any issuer redemptions would not be in reliance on the iPath no-action Regulation M relief.
  
  o Issuers should avoid stopping and then starting ETN issuances
  
  o TVIX: Credit Suisse temporarily stopped issuing ETNs, followed shortly by new issuances. Due to supply and demand, the ETN prices increased and decreased independently of the performance of the underlying index. Recently, the SDNY granted Credit Suisse’s motion to dismiss the plaintiff ETN investor’s Section 11 claims, relying significantly on the risk factor disclosure in the pricing supplement.
The ETN Sweep Letter (cont’d)

What are ETN issuers doing in response to the sweep letter?

• Most modern ETN prospectuses address the disclosure issues raised by the sweep letter
  o The letter seems to be in response to some of the original ETN prospectuses, which don’t have the most up-to-date disclosures

• Indicative value: the iPath no-action letter used the phrase “intrinsic economic value” to describe the issuer’s valuation of the ETN, as reflected in the indicative value
  o We are starting to see refiled and updated older ETN prospectuses, and that phrase has been deleted and a more fulsome, plain English explanation of the indicative value is included
Index Governance and Compliance
Overview

• Structured products are often linked to proprietary or novel indices. Proprietary indices may raise issues under the Securities Act of 1933, the Investment Company Act of 1940 and the Investment Advisers Act of 1940

• General issues to consider

  • Is the index created by the issuer or an affiliate ("proprietary") or by a third party?
  • Will there be adequate disclosure about the index and its methodology?
  • Are there elements of discretion in the index, thus raising ICA or IAA issues?
  • How does the index compare against a benchmark such as the NYSE listing rules?
Proprietary Indices

• Proprietary index information
  • If an affiliate of the investment bank, or a group within the investment bank, creates or maintains the index, then that index provider must be walled off from those who structure and market the product
    • Those who create and market the structured product cannot influence the index features or its components
  • NYSE Arca Equity Rule 5.2(j)(6)(C): “If the value of an Index-Linked Security listed under Rule 5.2(j)(6) is based in whole or in part on an index that is maintained by a broker-dealer, the broker-dealer shall erect a ‘firewall’ around the personnel responsible for the maintenance of such index or who have access to information concerning changes and adjustments to the index, and the index shall be calculated by a third party who is not a broker-dealer”
  • A separate group within the investment bank should be responsible for any index development
Proprietary Indices (cont’d)

• Window cleaning
  • If the index concentrates in a few equity securities, the issuer of the product and the broker-dealer should perform "window cleaning" procedures
  • Window cleaning procedures are comparable to those used when issuing a product linked to a small basket of stocks, or when linking to a non-proprietary index that has a high concentration in a particular security
  • These procedures should prevent the issuance of a product linked to a security with respect to which the broker-dealer possesses material non-public information, or as to which the broker-dealer's research arm has a negative rating or recommendation
    - Concerns diminish somewhat when there are a large number of index constituents
Third-Party Indices

• If the index is generated by a third-party provider
  • Perform diligence on the third-party provider
    – Do they have sufficient experience?
    – Does the sponsor periodically conduct internal reviews to ensure that the index methodology is consistently and accurately applied?
  • Will the third party be the index sponsor, or play any other role?
  • Will a license be required?
  • Ensure that the index sponsor has protections in place against the misuse of material, nonpublic information
    – NYSE Arca Equity Rule 5.2(j)(6)(C): “Any advisory committee, supervisory board or similar entity that advises an index licensor or administrator or that makes decisions regarding the index or portfolio composition, methodology and related matters must implement and maintain, or be subject to, procedures designed to prevent the use and dissemination of material, non-public information regarding the applicable index or portfolio”
Disclosure Issues

• The index methodology should be publicly available
• A link to the methodology is recommended
  • A detailed methodology is essential if the index were to be transferred to another sponsor; the methodology will ensure continuity
  • Opaque methodologies with formulae:
    – Translate into plain English
    – How to summarize — risk of error
    – Include complex formulae in the offering document?
• Roles: index sponsor, calculation agent, information dissemination
  – Disclose any conflicts of interest
• Are there similar indices to compare against, with appropriate disclosure as to the differences?
• Quarterly high and low closing levels of the index and the daily closing level should be publicly available free of charge at the close of business on each trading day
NYSE Listing Rules


- SEC has approved certain “generic” NYSE listing rules

- Equity Index-Linked criteria for indices (summarized)
  - Minimum of ten constituents
  - Minimum market value per component of at least $75 million
  - Minimum monthly trading volume
  - No single component can be more than 25% of the dollar weight of the index, and the five highest dollar-weighted components cannot exceed 50% of the dollar weight (60% for an index of fewer than 25 components)
  - 90% of the index’s weight and at least 80% of the number of components must be eligible for standardized option trading on the NYSE. Requirement doesn’t apply if:
    - no underlying component represents more than 10% of the dollar weight of the index; and
    - the index has a minimum of 20 components
  - General themes
    - indices with more than 20-25 components are subject to fewer requirements
    - Avoid top-heavy indices
    - Actively traded components
Regulatory Hot Buttons

• FINRA Report on Conflicts of Interest
  • Focuses on potential conflicts arising when an index calculation agent is an affiliate of the issuer or the underwriter
  • Highlights that in the context of a structured product the performance of which is linked to a proprietary index (created and maintained by the product issuer) there may be hidden costs, which may be high and may be difficult for an investor to assess
Regulatory Hot Buttons (cont’d)

• European benchmark index rulemaking
  • In the aftermath of the LIBOR/EURIBOR investigations, there has been increased focus on measures that are intended to promote index transparency and restore investor confidence
  • Generally, guidance from IOSCO, ESMA and European Commission has focused on “benchmark indices”
  • Benchmark indices are understood to be more widely recognized and used indices, such as those produced by the exchanges, as well as interbank rates
  • Many of the measures under consideration take a very broad brush approach that would apply to proprietary indices as well
Regulatory Hot Buttons (cont’d)

What is a Benchmark?

IOSCO: Prices, estimates, rates, indices or values that are:

• Made available to users, whether free of charge or for payment;
• Calculated periodically, entirely or partially by the application of a formula or another method of calculation to, or an assessment of, the value of one or more underlying Interests;
• Used for reference for purposes that include one or more of the following:
  o determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments;
  o determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of a financial instrument; and/or
  o measuring the performance of a financial instrument.

The definition may encompass proprietary indices.

Prices of single financial securities are not considered Benchmarks.
Regulatory Hot Buttons (cont’d)

- ESMA Principles
  - Emphasize good governance, sound methodology and transparency, in order to limit the risks of conflicts of interest and manipulation
  - Two approaches suggested: a governance-based approach and a transparency-based approach
  - Governance-based approach
    - Governance mechanisms to set up and calculate indices
    - Requires an independent committee to oversee the production of indices
    - The committee would be responsible for approving the rules for the indices
  - Transparency-based approach
    - Disclose to regulators and the providers’ clients the methodology for calculation of the index and the sources of data used
Regulatory Hot Buttons (cont’d)

• ESMA Principles (cont’d)
  • Information sources: the principles address sourcing of the inputs for the index (third party information versus solicited quotes, for example)
  • Past performance: the principles emphasize that retail clients should be able to access index past performance data
  • Continuity: once an index is created, there is a strong interest in continuity of the index, so this requires considering how a successor to the index provider or index calculation agent would be identified
Regulatory Hot Buttons (cont’d)

• Proposed European legislation
  • Addresses governance and controls, including by introducing
  • A code of conduct for each benchmark index
  • Conflicts of interest requirements
  • An audit requirement for the index
  • Recordkeeping requirements in order to establish an audit trail for the index
  • Notification to ESMA of the introduction of a financial instrument referencing an index
Index Administration

Because IOSCO, ESMA and the pending EU Parliament rules significantly raise the bar on indices and index administrators, what should an issuer be doing now?

- Inventory all indices it maintains or uses
- How is the index used? Is the index used only for:
  - Research
  - Performance benchmarking by funds
  - Swaps
  - Publicly offered products
- What role does the issuer or any of its affiliates play?
  - Index sponsor
  - Calculation Agent
    - Are the roles clearly documented?
- Is there a written methodology for each index?
  - What are the criteria for changes to the methodology?
Index Administration (cont’d)

• Discuss with European colleagues whether there will be a global index governance committee, or whether there will be regional governance committees
• Consider whether there are any indices that could or should be discontinued
• Will the new product committee (or similar committee) be tasked with vetting new indices for compliance with the new standards?
• Which group manages or controls the indices?
• Who reviews and supervises changes to the index?
• What roles do third parties play in the index?
  o Are there pricing inputs from third parties?
    • Where do the prices come from?
    • Prices from active markets having observable transactions entered into at arm’s length are best
    • Less concern about indices that are based on data from regulated markets or exchanges with mandatory post-trade transparency requirements (e.g. SPX)
  o Who’s monitoring third party compliance with their agreements with the index sponsor or the issuer?
• Identify existing or potential conflicts of interest relating to the index
Presentation of Backtested Data

New indices have no performance history, so many issuers include backtested performance data.

Guidelines for presentation of backtested data:

• Backtested data must be objective and capable of reproduction
  o Based on objective formulae and models applied to past historical data
  o Use the same methodology as used to calculate the index, with appropriate disclosure as to any differences in the application
  o An independent third party, or a skilled investor, should be able to independently reproduce the backtested data.
  o Necessarily, this excludes presenting backtested data for indices that are “managed”; i.e., where discretion is used in calculating the level of the index.
Presentation of Backtested Data (cont’d)

• Backtested data must cover a time period long enough to include a variety of market conditions, including stressed periods
  o Five-year backtested data eventually will not include the period from 2008 - 2010. Issuers should consider using longer periods, when necessary, to include periods representing different market conditions in order to show investors how the index might perform in similar future periods
  o Avoid “cherry picking,” or presenting backtested data that shows only periods when the index would have performed optimally
Presentation of Backtested Data (cont’d)

- Include appropriate disclosure about the backtesting methodology and appropriate risk factors highlighting the difference from historical data
  - Include additional disclosure that explains how the data was derived (including any assumptions and the impact of fees), that the data is hypothetical and not actual, was created with the benefit of hindsight and that the backtested data cannot accurately predict future results
  - Include risk factor disclosures that explain that backtested data is not necessarily accurate and is not predictive of future performance
  - Disclose that there may be conditions (e.g., very high or low interest rate environments) for which the backtested data may not be effective
  - If the index has actual historical performance results, the backtested data may be presented alongside the historical data, with an explanation of the two time periods and any differences in the data