MORRISON | FOERSTER

Master Class

Exchange Traded Notes

November 20, 2014
Presented By
Bradley Berman

NY2-743127

©2014 Morrison & Foerster LLP | All Rights Reserved | mofo.com

What Are ETNS?

ETN = Exchange Traded Note

- ETNs are senior, unsecured, unsubordinated debt securities. They are designed to track the return of a specific market index, less investor fees, and provide investors with exposure to the returns of various market indices, including indices linked to stocks, bonds, commodities and currencies.

- ETNs are currently listed on NYSE Arca or Nasdaq and are available for purchase similar to other publicly-traded securities.

How Do ETNS Work?

ETNs are available to retail investors and typically are sold in $25 or $50 denominations.

- But newer ETNs are becoming more sophisticated and complex, as discussed below; and
- Consequently, many ETN prospectuses now state that they are trading products for sophisticated investors who seek to manage their portfolios with daily or monthly reset products (including leveraged and inverse ETNs).

ETNs typically are non-interest-bearing and non-principal protected and have long maturities (e.g., thirty years from original issuance).

- Variation: some ETNs may pay a coupon representing the value of any dividends that an imaginary holder of the equity securities comprising the underlying index would receive.

How Do ETNS Work? (cont'd)

If ETNs are held to maturity –

- in accordance with the terms of the ETN, at maturity, ETN holders would receive a cash payment equal to the principal amount of the ETNs, multiplied by the applicable "index factor," less any applicable investor fee;
- an index factor on any given day is typically the ratio of the closing value of the relevant index on that day over the closing value of that index on the original pricing date of the ETNs; and
- the investor fee is typically a stated percentage per annum, multiplied by the principal amount of the ETNs, multiplied by the index factor, calculated daily.

How Do ETNS Work? (cont'd)

If ETNs are to be disposed of prior to maturity –

- ETNs may be sold (or purchased) throughout the trading day on the exchange or over the counter at current negotiated prices; and
- alternatively, ETNs may be tendered for redemption on at least a weekly basis in large minimum amounts specified by the issuer in the terms of the ETN – upon redemption, the redeeming holder would receive a cash payment equal to the principal amount of the ETNs being redeemed, multiplied by the applicable index factor, and less any applicable investor fee and/or redemption fee.

How Do ETNS Work? (cont'd)

ETN payout structures have become more complicated.

- Daily or monthly resets: the "Current Principal Amount" is reset and recalculated on a daily or monthly basis. The "index performance ratio" is a comparison of the index closing level on the reset day as compared to either the previous day's or month's level.

- Issue: Rather than the note measuring against the index closing level at the initial trade date, the value of the ETN is now measured against a daily or monthly index closing level. Consequently, even if the index closing level at a month-end is higher than the index closing level on the initial trade date, the Current Principal Amount will be reset based on the change in the index closing level from the previous month. If the index closing level on the reset date is lower than the index closing level at the last month's reset date, the Current Principal Amount will decrease, even if the index closing level on the reset date is higher than the index closing level on the initial trade date.

- Leverage: ETNs now come in short and long versions, with 2-3 times leverage.

- Not for Mom and Pop anymore.

ETN Regulatory Framework

The iPath No Action Letter (2006):

Due to ongoing ETN creations, the “distribution period” under Regulation M is continuous. This raised an issue, as the ETN issuer needs to be able to redeem ETNs, and its affiliated broker-dealer needs to conduct market-making, during that distribution period. Without relief from the Staff, the redemptions and market-making activities would have violated Regulation M.

- Rules 101 and 102 of Regulation M generally prohibit a “distribution participant,” and the issuer or a selling security holder, respectively, in connection with a distribution of securities, from bidding for or purchasing or from attempting to induce any person to bid for or purchase, a “covered security” (like ETNs) during the applicable restricted period.
- The requirements for relief from Regulation M are liquidity, real-time dissemination of information on the value of the ETN and the underlying asset and the ability to redeem.

ETN Regulatory Framework (cont'd)

- ETNs are listed on the NYSE Arca, which requires dissemination of the value of the underlying asset at least every 15 seconds during normal trading hours.
- Because the ETN is listed, the value of the ETN is constantly available.
- In the iPath letter, counsel argued, and the Staff agreed, that the activities of arbitrageurs (redeeming, or purchasing ETNs from the issuer) would minimize any differences between the value of the ETN and the underlying asset.
- In a perfect world … but see TVIX.
- When evaluating proposed features of an ETN, the iPath No Action letter requirements must be considered.

<u>Why is this not a problem with a typical debt security?</u>

The distribution period for a typical debt security would end at the closing; non-ETN debt securities are not continuously offered by the issuer.

ETN Regulatory Framework (cont'd)

The ETNs must satisfy the NYSE Arca rules for Equity Index-Linked Securities (Rule 5.2(j)(6)), including the continued listing criteria (which mandates dissemination of the underlying index level on at least a 15-second basis).

Rule 5.2(j)(6) allows for the listing of securities linked to the following underliers:

- An index or indexes or equity securities;
- One or more physical commodities or commodity futures, options or other commodity derivatives or a basket or index of any of the foregoing;
- One or more currencies, or options or currency futures or other currency derivatives, or a basket or index of any of the foregoing;

ETN Regulatory Framework (cont'd)

- One or more indexes or portfolios of notes, bonds, debentures, or evidence of indebtedness, including Treasury Securities, government-sponsored entity securities (GSE Securities), municipal securities, trust preferred securities, supranational debt and debt of a foreign country or a subdivision thereof, or a basket or index of any of the foregoing (summary);
- An index of (a) futures on Treasury Securities, GSE Securities, supranational debt and debt of a foreign country or a subdivision thereof, or options or other derivatives on any of the foregoing or (b) interest rate futures or options or derivatives on the foregoing in this subparagraph (b) or (c) CBOE Volatility Index (VIX) Futures (summary); or
- A Multifactor reference asset – a combination of two or more of the above underliers, which may also include a cash component based on a widely accepted overnight loan interest rate, such as LIBOR or the Prime Rate.

Note that VIX futures are the only permissible equity futures.

There are also issuer suitability standards.

ETNS In The News

The idea behind the iPath Regulation M relief was that the ETNs, due to liquidity and the activities of arbitrageurs, would always be valued close to the value of the underlier.

A notable exception, which drew the SEC's attention:

- The Credit Suisse AG VelocityShares 2X Long VIX Short-Term ETNs (TVIX) began to trade significantly above the value of the underlier, followed by a significant and sudden drop in value.
- Credit Suisse announced that they wouldn't issue any more shares, due to internal position limits (prospectus supplements typically disclose that the issuer may not issue the full amount on the cover of the prospectus supplement and may stop issuing at any time). The TVIX crash came shortly thereafter, when Credit Suisse announced new issuances.
- Barclays Bank plc stopped issuing new shares of its iPath DJ-UBS Natural Gas Subindex TR ETNs (GAZ) in August 2009. On May 18, 2012, Barclays issued a press release noting that the GAZ ETNs have consistently traded at a fluctuating premium to their intraday indicative value, and warned that these ETNs are not suitable for most investors.

FINRA Investor Alert

FINRA published an Investor Alert on July 10, 2012 titled “Exchange-Traded Notes – Avoid Unpleasant Surprises”.

The alert:

- Reiterated FINRA’s concerns, previously expressed with respect to ETFs in 2009, that ETNs with leverage and reset features should not be sold to retail investors;
- Warned that leveraged and inverse ETNs with resets are more appropriate for investment professionals;
- Highlighted that there may be a significant difference in the “indicative value” of an ETN and its actual trading price (the TVIX situation was referenced, but not named); and
- Listed general risk factors relating to ETNs.

The ETN Sweep Letter

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:
  - What is it, and why is it relevant?
  - Avoid formulas, clearly explain the elements of indicative value
  - 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.
  - 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 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.

- 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.
  - Issuers should avoid stopping and then starting ETN issuances
  - 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

ETN Documentation

- Prospectus Supplement (typically for $100,000,000 but only a minimum of $4,000,000 must be sold on the trade date, to satisfy NYSE listing requirements; may be sold to an affiliate of the issuer); the balance can be held in inventory;
- Form 8-A, with form of note as an exhibit;
- NYSE supplemental listing application;
- Regulation M representation to the NYSE; and
- Exhibit 5 validity opinion (may be included in the prospectus supplement) and possibly an Exhibit 8 tax opinion.

ETN Documentation (cont'd)

Risk Factors

- Liquidity risk factors are important in ETNs; a typical risk factor notes that the notes may become delisted.
- In that event, creations would have to stop (which would end the Reg M distribution period) because the Regulation M relief provided by the iPath letter would be in doubt.
- Since TVIX, ETN issuers have increased their risk factors relating to the possibility of the notes trading at a premium or discount to their indicative value, particularly if there are any internal issuance limits in place.

Index description

- Many ETNs are linked to new, proprietary indices;
- Consequently, historical and estimated historical performance of the index should be presented;
- Note that estimated historical, or "backtested," index data must be clearly labeled and with appropriate warnings (see SEC sweep letter – query to issuers whether backtested data is used and if it is presented in a balanced manner);

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
  - Based on objective formulae and models applied to past historical data
  - Use the same methodology as used to calculate the index, with appropriate disclosure as to any differences in the application
  - An independent third party, or a skilled investor, should be able to independently reproduce the backtested data.
  - 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
  - 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
  - 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

ETNS and Estimated Initial Value Disclosure

Issues:

- Only a small portion of the full prospectus amount is issued on the settlement date; this amount may have an estimated initial value that is less than the price to public;
- All other creations, and secondary market trading, will be at market values;
- ETNs are listed and have much more liquidity than a typical unlisted structured note; consequently, holders can sell their notes, or redeem them, at known amounts (NYSE or Nasdaq prices).