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# Structured Thoughts

News for the financial services community.

*IN THIS ISSUE:*



## Structured Products Offerings and Research Reports

### Introduction

Structured products are sold by broker-dealers, many of which are affiliates of large investment banks. The equity research group of the same investment bank may have useful research reports that help explain why a strategy of investing in a certain stock, index or sector could be an excellent investment. That research could also help explain to an investor the types of risks that such an investment may pose. In some cases, it's even possible that a structured note may be designed around one of the themes set forth in the research.

In all of these cases, it would seem that the structured product and the equity research would make great partners, and the research reports would constitute useful materials to be shared with an investor in the structured note.

But not so fast. A variety of SEC and FINRA rules limit the manner in which research reports can be used in connection with an offering, particularly in the context of a registered debt offering. This article examines some of these issues.

### FINRA Rules

NASD Rule 2711 regulates research reports and their preparation. Rule 2711(b)(2) generally prohibits personnel outside of the research group from reviewing the research prior to its publication. As a result, the rule bars structured note developers and marketers from gaining pre-publication access to research reports, whether for the purpose of structuring new notes, or for planning the disclosures that will be made in the new offering documents.

**Information Walls**

Rule 2711(b)(1) also prohibits research analysts from being subject to the supervision or control of personnel in the investment banking department. Any such control, or any influence over research analyst compensation, would call into question the integrity of the research.

For these reasons, and due to the prohibition on pre-public review of the research reports, investment banks will establish information walls and separations between the research group and the structurers and marketers of a variety of investment products, including structured products. These walls are designed to ensure that the research and banking groups remain separate, that the research group will not be consulted or involved in the structuring of any product, and that the research group will not provide advance notice to the product structurers of any anticipated research reports, research views, or changes to research-based indices.

**Free Writing Prospectuses**

A knotty issue can arise when a broker wishes to provide copies of a research report to potential investors in a structured note.

The SEC historically has broadly defined the terms “offer” and “prospectus.” If a research report is used in connection with a securities offering, whether to tout the reasons why the investment is a promising one, or even to disclose the risks that may arise from such an investment, the research report could be viewed as a prospectus.

This characterization would have a variety of negative consequences.

First, the accuracy of the research report, or the basis for any recommendations made in the research report, could be challenged in litigation for any poorly performing structured note. Because research reports are not prepared with a view to the liability provisions of the 1933 Act (for example, they typically include a variety of estimates and forecasts that issuers and underwriters would be quite reluctant to include, and may not be appropriate to include, in a prospectus), few parties would want to take the risk of liability for their contents. In addition, if they are in fact deemed to be prospectuses, if they do not comply with the SEC’s legending and filing requirements for free writing prospectuses under Rule 433, they could potentially create a rescission or damages claim from investors, even if the information therein is not, in and of itself, actionable.

The “Rule 433 considerations” do not apply in the context of unregistered offerings, such as structured certificates of deposit, unregistered bank notes and Rule 144A offerings. However, many broker-dealers apply their policies consistently, particularly as to offerings involving retail investors and high net worth investors, due to liability considerations and other related factors. In addition, we note that the Rule 433 considerations apply not only to underwriters, but also to other “offering participants,” such as distributors that are party to an MSDA or similar agreement with the underwriter

**A Few Practical Considerations**

How do brokers address these limitations?

First, most brokers have a standing policy not to send research reports to investors that have been offered, or are expected to be offered, a structured note that may reference a security or index that is the subject of research. (These types of policies do not bar brokers from sending research reports in the ordinary course, in accordance with their standard policies.)

Oral communications between a broker and customers relating to research can be more complicated to police. On the one hand, a broker can presumably orally advise a customer that the “thesis” of a note is supported by, or is not inconsistent with a recent research report. On the other hand, doing so will often generate a request from the investor to receive a copy of that report. Sending that report would be problematic once the specific offering is discussed, as discussed above. A response such as “our lawyers do not allow us to send the research report now that we have discussed the note” is not likely to help the sales process. Accordingly, many broker-dealers will bar their representatives from discussing the research with customers.

Some structured notes are based around a particular strategy recommended by research, such that it is may be helpful to indicate in the offering documents the nature of the research. In these cases, the offering document may discuss the research in summary, while also noting (in the risk factors section, and/or other parts of the prospectus) that:

- the relevant underlying stocks or other assets are based on research recommendations, which are only opinions as of a particular time, and may change;
- the research views are generated without regard to any specific investor's overall holdings, circumstances and investment needs, and the related investment may not be suitable for all investors; and
- the research views are separate from the offering of the structured product.

## Structured Products and Index License Agreements

### Introduction

Since the dawn of the structured products industry, issuers and underwriters have entered into license agreements with index sponsors. These agreements enable the parties to the offering to use the index and its levels in connection with the offering of these products.

A number of developments in the area have made the drafting and negotiating these license agreements a bit more time-intensive. For example, issuers are linking to an increasing number of new indices. In addition, market participants are increasingly interested in the extent to which an index and its methodology are transparent.

In this article, we discuss a variety of items to consider in preparing these agreements.

### Which Entities Should Be Covered?

Depending upon the circumstances, the issuer or the underwriter may be party to the license agreement. But no matter which entity is the contracting party, the entities entitled to rely on the agreement must be considered. For example, will an affiliate of the licensee, such as a finance subsidiary or a new trust entity, be the actual issuer of the product? Or if the underwriter is the licensee, will that underwriter seek to use the index with more than one issuer? The agreement must be prepared to ensure that the relevant entities will have the right to use the license in connection with an offering. (And of course, from the perspective of the index provider, the relevant revenue stream under this agreement may depend upon which parties, and how many parties, are entitled to issue products in reliance upon it.)

### What Products Are Covered?

At the time a license is first granted, an issuer may have a specific product in mind, such as an ETN. However, if the product is successful, the licensee may wish to use the index for other products, such as other types of structured notes, CDs, structured warrants or OTC derivative instruments. The scope of the license agreement should be considered in connection with the licensee's future issuance plans.

### Geographic Scope

Similarly, a product may be initially planned for offering under a specific "wrapper," such as a U.S. MTN. That being said, the licensee should be careful about limiting the scope of the license solely for use in, for example, the U.S. and its territories. Many U.S. registered offerings, and other types of offerings, involve a certain number of offerees outside of the United States. And it is always possible that if an offering is successful in one jurisdiction, a broker may seek to extend its use in other markets that it serves as well.

### Exclusivity

Obtaining an exclusive right to use an index for a particular type of structured products may provide a competitive advantage to the licensee. On the other hand, the licensor is likely to charge increased license fees for this privilege. A licensee seeking an exclusive license may also wish to have the option to convert the license to a non-exclusive license, at a lower cost.

### Transparency

Licensees may wish to negotiate agreement terms that help ensure that the index will remain a suitable reference asset over time, and in a variety of regulatory environments. Accordingly, the licensee may request the index provider to:

- Maintain at all times a publicly available index methodology, and to update it on a timely basis if there are any changes to the methodology;
- Publish on a daily basis (or other agreed basis) the current level of the index, its historical performance and its constituents;
- Agree that it will not receive any payments or other consideration from any potential index components or other third parties as an inducement to include (or exclude) any component from the index;
- If it provides "preinception performance information," to prepare that information using the same index methodology that is currently in effect;
- Provide advance notice of any expected changes in the index methodology;
- Maintain appropriate index governance, supervisory and audit mechanisms; and
- Source pricing information from index components solely from independent third party providers.
- Maintain information walls that separate the individuals and divisions calculating and maintain the index from any other groups within the entity that could have an incentive to manipulate the index, such as trading or investment banking groups.

**Training and Support**

In the case of a new index, the licensee may wish the index provider to supply training sessions for the relevant salesforce as to the nature of the index, its construction and any risks that arise from the use of the index. Of course, the scope of any such training will depend upon the relative needs of the licensee, and the capabilities of the licensor.

**Avoiding Burdensome Document Approval Obligations**

An index provider may wish to approve any prospectuses or market materials relating to its index prior to their use. While that may not be an unreasonable concept, any such provisions in a license agreement have to be drafted in light of the speed at which structured product offerings are conducted. For example, the 2-day window for filing a final pricing supplement under SEC Rule 424(b) may be inconsistent with a 30-day advance approval requirement for an index provider of any materials, if the index provider is insistent on reviewing all these documents. In that regard, a provision may be drafted so that, once a description of an index is approved for use by the index provider, the licensee may continue to use it in other similar offering documents with receiving further approvals from the index provider.

**Required Index Disclaimers**

It is usually fair for an index provider to require the issuer to state the limited obligation of the index provider in connection with the structured product. This is usually done through required disclaimer language. However, any such language should be carefully considered so that (a) in connection with any short term sheets or FWPs, the required disclaimer isn't three times the size of the other disclosures and (b) the language can be modified a bit to reflect the circumstances of the offering. (Notes vs. CDs, etc.) This can be accomplished through provisions that allow a shorter disclaimer to be used for shorter marketing materials, and provisions that permit required disclaimers to be stated with minor modifications.

**Renewals**

Depending upon its planned use of the index, the licensee may wish to have a license agreement that automatically continues at the end of one or more terms, if not previously terminated by one of the parties.

**License Agreement Administration**

Frequent issuers should maintain a readily available "library" of their index licenses agreements, together with a list of their inventory and any relevant expiration dates. Calendar reminders can also be implemented as to any key dates. Having these mechanisms in place will often make it easier to launch new offerings, as the status of any required licenses, and any required license agreement language, will be easier to obtain.

**Intellectual Property Issues**

And of course, no discussion of license agreements would be complete without a discussion of IP issues…

The provisions granting the relevant license should be carefully reviewed to make sure that they grant a license to use the index data and the licensor's trademarks as intended in connection with the offering of the relevant products. The index provider should ideally indemnify the licensees, without any limitation on dollar amount, for any damages caused if the licensee's use of the index or the trademarks is challenged by a third party.

## Structured Notes and the Fed's Long-Term Debt and TLAC Proposal

On October 30, 2015, the Federal Reserve Board issued its notice of proposed rulemaking relating to U.S. bank holding companies which are G-SIBs and the intermediate holding companies of foreign banking organizations which are G-SIBs. Among other things, U.S. G-SIBs will be required to maintain a minimum amount of unsecured long-term debt and a minimum about of total loss-absorbing capital ("TLAC").

For readers of this publication, we would point out in particular that eligible external long-term debt instruments would not include most types of structured notes that are currently issued by U.S. bank holding companies. This is due to the broad definition of "structured note" that has been proposed.

For purposes of these provisions, a "structured note" is a debt instrument that:

- has a principal amount, redemption amount, or stated maturity that is subject to reduction based on the performance of a reference asset or embedded derivative;
- has an embedded derivative that is linked to one or more reference assets;
- does not specify a minimum principal amount due upon acceleration or early termination; or
- is not classified as debt under U.S. GAAP.

As a result, the proposed limitation applies both to principal protected and to non-principal protected structured notes. However, the definition expressly excludes non-dollar dominated instruments, as well as some rate-linked notes, such as floating rate notes linked to LIBOR. (For example, a conventional fixed to floating rate note linked to LIBOR, which is not callable at the option of the issuer, would appear to be eligible for inclusion.)

Since the proposed rules apply at the bank holding company level only, these rules would not impact structured bank notes (issued by a bank subsidiary) or "structured CDs" issued by a bank subsidiary. One also could envision structured notes issued by subsidiaries of the bank holding company, if these are not guaranteed by the relevant bank holding company.

To see our more detailed November 1st client alert relating to these developments, please use the following link: http://www.mofo.com/~/media/Files/ClientAlert/2015/11/151101tlac.pdf

## SEC Sanctions Broker-Dealer and Affiliated Asset Manager for Breaching Information Barriers for ETNs

On October 8, 2015, the Securities and Exchange Commission charged an investment adviser and a broker dealer for failing to maintain and enforce polices to prevent misuse of material non-public information. According to the SEC's order instituting administrative proceedings, the broker-dealer and the affiliated asset manager repeatedly shared information about their trading positions for an exchange-traded note (ETN) whose market price traded at a premium to its intraday indicative value after new issuances of the note were temporarily suspended. Despite information barriers between the respondents that were in place, the SEC charged, traders from both affiliates met to discuss issues relating to the ETN. This sharing of information, the SEC said, violated the information barriers and created an unfair advantage for the affiliated asset manager.

As a result of the trading of material non-public information, the asset manager profited from a market opportunity that it should not have received, according to the SEC.

*Our take.* This matter underscores the importance of creating and enforcing information barriers that separate trading and investment management functions. By sharing material non-public information across the barrier, affiliated firms risk a "blending" of information among affiliates, creating opportunities that other market participants did not have. The SEC focused on the fact that the affiliates simply did not enforce written policies and procedures in place. The case is a not so subtle reminder that the SEC views prevention of insider trading as a compliance priority.

## FINRA's Revised Proposal on Required Firm Disclosures in Customer Confirmations

In October 2015, FINRA released Regulatory Notice 15-36,[1] which sets forth proposed rules for broker-dealers to disclose additional information on customer confirmations. The new notice modifies the rules initially proposed by Regulatory Notice 14-52,[2] which was issued in November 2014. The proposed rule would govern retail-sized customer trades in corporate and agency debt securities. The proposal would require that, if a FINRA member sells to a customer as principal, and on the same day buys the same security as principal from another party, the firm would have to disclose on the customer confirmation: (i) the price to the customer, (ii) the price to the firm of the same-day trade (reference price) and (iii) the difference between those two prices.

The prior proposal limited the disclosure to retail customer trades of 100 bonds or less or a value of $100K or less. The revised rule would, in lieu of the size requirement, require the information to be set forth in connection with sales to "retail accounts," which are accounts other than "institutional accounts" (as defined in FINRA Rule 4512(c)).

The revised proposal also provides for alternative methodologies to calculate the reference price required for the disclosure, and outlines guidelines for firms to follow in determining this figure. These guidelines provide more flexibility than Notice 14-52 by permitting firms engaged in "complex transactions," where there are multiple firm trades equalling or exceeding a customer trade, a potentially more cost-efficient alternative to calculate the reference price.
The proposed rule creates an exception to the required disclosure, where there was an unusual and material change in the market price for reasons beyond typical market fluctuations. In these circumstances, firms can opt either to not disclose the reference price or to disclose the figure with further clarifying information. Lastly, in addition to the aforementioned reference price, FINRA proposes requiring firms to include links to publicly available TRACE data in their confirmation disclosure, in order to provide statistics to customers about market activity, measuring the number of securities, total par amount, most active bonds by day, and 52-week highs and lows, among other metrics.

FINRA seeks comment on the potential costs that the proposed regulation will have on firms and whether these requirements would have a negative impact on firm behavior. Notice 15-36 substantially revises the prior rule proposal; however, the new proposed rule's application to structured notes remains significant, as many structured notes would be covered. The "corporate debt securities" covered by the proposed rule continue to exclude "money market instruments," which are debt securities (including structured notes) that have a maturity of one year or less, such as some types of structured notes.

The comment period will expire December 11, 2015.

[1] Regulatory Notice 15-36 may be found at the following link: https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-15-36.pdf

[2] Regulatory Notice 14-52 may be found at the following link: https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_14-52.pdf

## FINRA Issues Investor Alert on Fraudulent Binary Options

In October 2015, FINRA issued an investor alert, "Binary Options: These All-Or-Nothing Options Are All-Too-Often Fraudulent." The alert, and FINRA's related press release, may be accessed at the following link: http://www.finra.org/newsroom/2015/finra-investor-alert-binary-options-these-all-or-nothing-options-are-all-too-often

FINRA's first concern is inherent in many types of option contracts or warrants: binary options can be "all-or-nothing propositions," in that they can expire worthless. In addition, and in what appears to have triggered the alert, based on calls to its senior citizen investor hotline, FINRA has identified a variety of fraudulent schemes involving these instruments. These schemes often originate from unregulated entities operating outside of the U.S.

This is not necessarily a new problem; the SEC issued a somewhat similar alert in 2013,[3] as has the CFTC.[4]

The fraudulent acts committed against investors have typically involved one or more of:

- Refusing to credit customer accounts or to reimburse investor funds;
- Identity theft; and
- Manipulation of software to generate losing trades.

These schemes could be confused by some investors with structured warrants or some types of structured notes. But of course, structured warrants and structured notes sold to retail investors are typically registered with the SEC, and offered by registered broker-dealers that are regulated by FINRA.

## FINRA Adopts Revisions to Rule 2210 to Require a BrokerCheck Link on Members' Retail Websites

On October 8, 2015, the SEC approved an amendment to FINRA Rule 2210 (Communications with the Public) under which each member firm's website must include a readily apparent reference and hyperlink to FINRA's BrokerCheck page.[5] The new reference and link must be included on the initial webpage that the member intends to be viewed by retail investors and any other webpage that includes a professional profile of one or more registered persons who conduct business with retail investors. This new requirement does not apply to a member that does not provide products or services to retail investors, or to a directory or list of registered persons limited to names and contact information.

In a comment response letter, FINRA explained its view of the scope of the amendment in several areas:

- A website operated by registered representatives that promotes the member's business is viewed by FINRA as the website of the member firm, and FINRA expects member firms to supervise and review this type of website for compliance.
- For websites of multi-faceted financial institutions, the new requirements would apply only to the affiliated broker-dealer's main webpage and not to the enterprise level webpage.
- The rule applies to a separate retail website of a branch office or branch office personnel, which would be treated as separate websites of the member.
- The hyperlink and reference would be required for all webpages where a branch office registered person's profile information appears, including webpages on the member's website and webpages on the branch office's website.
- A hyperlink and reference included in a footer would not be "readily apparent."[6]

[3] The SEC's investor alert may be found at the following link: http://www.sec.gov/investor/alerts/ia_binary.pdf

[4] The CFTC's investor alert may be found at the following link: http://www.cftc.gov/ConsumerProtection/FraudAwarenessPrevention/CFTCFraudAdvisories/fraudadv_binaryoptions

[5] F5 80 Fed. Reg. 62,137 (2015)

[6] F6 See Letter from Jeanette Wingler, Assistant General Counsel, FINRA, dated September 21, 2015, available at: http://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2015-022-response-to-comments.pdf.

Please note that the rule does not limit the placement of the link to the broker's homepage for its enterprise. Rather, the rule contemplates placement of the link on each initial webpage that the member intends to be viewed by retail investors. Accordingly, FINRA contemplates the possibility that a broker will have multiple pages requiring BrokerCheck links, for example, where it manages "microsites" relating to different aspects of its business.

In the case of structured note websites, it is possible that FINRA members will need to place the link on a number of webpages. For example, the broker may have specially designed structured product webpages, which are intended to be the investor's first point of on-line exposure to the broker's structured products business. Brokers will need to review their relevant webpages to determine which ones are appropriate to insert the relevant links.

## Final and Temporary Dividend Equivalent Regulations Issued

On September 17, 2015, the IRS released final and temporary regulations under Section 871(m), the Internal Revenue Code provision that treats "dividend equivalents" paid under certain contracts as dividends from sources within the United States and therefore subject to U.S. withholding tax if paid to a non-U.S. person. The regulations finalize regulations that were proposed in 2013, with significant changes.

Please see our November 2015 issue of "Tax Talk" for a more complete discussion, which can be found at the following link: http://www.mofo.com/~/media/Files/Newsletter/2015/11/151103TaxTalk.pdf

There, we discuss a variety of aspects of the new regulations, including the delta threshold, the timing of the delta determination, and the calculation of the delta, as well as the qualified index exception.

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**Morrison & Foerster was named Best Law Firm for Derivatives – US, 2015 by *GlobalCapital* at its US Derivatives Awards.**

Morrison & Foerster has been named Structured Products Firm of the Year, Americas by *Structured Products* magazine six times in the last ten 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, 2014 and 2015 by *Structured Retail Products.com*.

Morrison & Foerster was named Legal Leader, 2013 by *mtn-i* at its Americas Awards. Several of our 2015 transactions were also granted awards of their own as a result of their innovation.

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