

# Structured Thoughts

*News for the financial services community.*



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## Financing Subsidiaries and SEC Registration

As readers of this publication know, in order to address the expected new U.S. regulatory capital requirements, a number of U.S. bank holding companies have been creating new finance company subsidiaries. This article discusses a variety of SEC rules and regulations that simplify the registration process for using these entities, as well as certain limitations.

*Using the Parent Company's Registration Statement.* Under General Instruction I.C of SEC Form S-3, a wholly owned subsidiary of an S-3 eligible company can utilize the parent company's short form shelf registration statement for primary offerings of investment grade securities. This provision enables these subsidiaries to take advantage of the parent company's reporting status for purposes of effecting a shelf registration. This will be the case whether or not the parent corporation is a "WKSI" or a "non-WKSI" (including a WKSI that has become an "ineligible issuer").

*Separate Financial Statements?* Regulation S-X governs the financial statement requirements for registration statements and for periodic reports. Under Rule 3-10 of Regulation S-X, separate financial statements for a subsidiary with a parent guarantee are not required to be set forth in a registration statement if (a) that subsidiary is 100% owned (whether directly or indirectly) by the parent corporation, and if (b) the securities issued by the subsidiary are "fully and unconditionally" guaranteed by the parent corporation. Rule 3-10, as amended in 2000, builds upon some of the SEC's prior no-action guidance.

The SEC reached this position due to its reasoning:

"...if a finance subsidiary issues debt securities guaranteed by its parent company, full disclosure of the finance subsidiary's financial information would be of little value. Instead, investors would look to the financial status of the parent company that guaranteed the debt to evaluate the likelihood of payment."

*What Is a Finance Subsidiary?* A subsidiary will be a “finance subsidiary” if “it has no assets, operations, revenues or cash flows other than those related to the issuance, administration and repayment of the security being registered and any other securities guaranteed by its parent company.” If this condition is satisfied, then no financial information about it will be required in the parent company’s financial statements. The parent company’s financial statements must include a footnote stating that this entity is a 100%-owned finance subsidiary of the parent company and that the parent company has fully and unconditionally guaranteed the securities.

*New Form 10-K and Form 10-Q Requirements?* When creating a new SEC registrant, the “sponsor” will of course ask whether or not it is creating a burdensome and potentially expensive ongoing disclosure obligation under the Exchange Act. However, this need not be the case—under Rule 12h-5 under the Exchange Act, these financing subsidiaries are not required to file separate periodic reports.

*What Is a Full and Unconditional Guarantee?* Under Rule 3-10, for a guarantee to be deemed “unconditional,” when an issuer of a guaranteed security fails to make a scheduled payment, the guarantor is obligated to make the scheduled payment immediately and, if it doesn’t, any holder of the guaranteed security may immediately bring suit directly against the guarantor for payment of all amounts due and payable.

However, under the rules, a guarantee will not be “full and unconditional” if it is not operative until some time after default. For example, a subsidiary guarantee would not satisfy this condition if the debt holder must first proceed against the parent issuer, and then only proceed against the subsidiary if a certain amount of time has passed without payment.

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## Cover Page Disclosures for Structured Notes

### Overview

We conducted an informal analysis about cover page disclosures for structured notes. We looked at the pricing supplements for offerings from two different issuers that each had a fairly common structure:

- index-linked.
- 3x upside to a cap.
- 1-1 downside.
- No interest payments.

One pricing supplement expressed this structure with 1,133 words on the cover page. The other, did so with only 424 words.

Industry participants would read these cover pages and quickly realize how similar these two products are. But if a retail investor had each pricing supplement in hand, that investor might not realize so quickly how similar these offerings are. At least at a superficial level, these two offerings might seem somewhat different.

Of course, this quick study simply reveals what readers of this publication already know: disclosure documents and styles can vary significantly from issuer to issuer, and underwriter to underwriter. But what are the actual requirements of a structured note cover page? This article attempts to discuss that question.

### Regulation S-K

Of course, in the context of a registered public offering, we look first to Regulation S-K under the Securities Act of 1933 to tell us the black letter law of cover page disclosures. These requirements are set forth in Item 501(b). The cover page must:

- set forth the issuer’s name;
- set forth the title of the securities,<sup>1</sup> and the amount being offered;

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<sup>1</sup> Under the SEC’s guidance, the name cannot be misleading. For example, “debt securities” should not be described as “shares.” And as readers of this publication know, the term “principal protected” in a title is somewhat problematic.

- provide a brief description of the terms of the securities;
- set forth the public offering price<sup>2</sup> and the underwriting discount;
- indicate whether the securities will be listed on a stock exchange, providing the trading symbol (if applicable);
- set forth a cross-reference to the risk factors section;
- set forth a legend that the SEC has not approved of the securities or the offering;
- identify the underwriters,<sup>3</sup> and, if the offering is not a “firm commitment underwriting”, describe the nature of the plan of distribution; and
- set forth the date of the prospectus.

Item 501(b) requires the cover page to be limited to just that—the cover page. Of course, this can be a bit of a challenge in the case of complex products or complex underliers.

### The SEC Weighs In

As you know, the SEC has taken an active interest in cover page disclosures. As a result of the SEC’s 2012 sweep letter and its aftermath, pricing supplement cover pages for structured notes now include:

- estimated value disclosures.
- a reminder that payments on the notes are subject to issuer credit risk.

In addition, where the issuer is a bank holding company (and not a bank), the SEC has historically encouraged issuers to remind investors that these debt securities are not bank deposits, and are not insured by the FDIC.

### FINRA Corporate Financing Rule

One additional small requirement emanates from the FINRA rules. Where the underwriter is affiliated with the issuer, in order to obtain the exemption from FINRA filing for investment grade securities, the cover page of the offering documents for a non-registered offering must indicate that the conflict exists, and cross-reference the “Conflicts of Interest” subsection of the “Plan of Distribution” section. (FINRA Rule 5121(a).) Many registered offerings follow this approach as well (in addition to the separate, but related, “table of contents” requirement that does apply under the FINRA rules to registered offerings).

### Additional Disclosures

In addition to the required disclosures, some market participants have added a variety of additional provisions to their cover pages:

- suitability considerations;
- key risk factors, particularly the potential loss of principal (for “non-principal protected” notes);
- “structuring costs” and similar amounts; and
- explanations of the compensation that “selected dealers” will receive from underwriters.

Regulatory capital changes in Europe (and expected ones in the U.S.) will potentially cause some types of structured notes to convert into equity securities in the event of a failure. This feature also has been added to cover pages.

### Additional Marketing Materials?

Needless to say, different market participants have different views as to the best way to present all of the above information, and which of the “optional” information is best suited for a cover page. (The answer may depend upon the nature and sophistication of the investors.) That being said, the combination of regulatory requirements, and occasional

<sup>2</sup> Which is usually par for structured notes, unless there is a “bulk discount” or a lower price for advised accounts.

<sup>3</sup> “Selling group members” are not required to be specifically identified. They would often not wish to be identified, as doing so may increase the likelihood that they will be viewed as “statutory underwriters” for liability purposes.

complexity of structured notes, often leads to cover pages that not everyone will agree are the optimal solution. Accordingly, many market participants also rely on additional marketing materials, such as term sheets and offering summaries, to help present information in the manner that they believe is most helpful.

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## FINRA's Remarks at the Complex Products Forum: Evaluating Contingencies

On June 16, 2016, Thomas Selman, FINRA's Executive Vice President, Regulatory Policy, delivered a speech at SIFMA's annual Complex Product Forum in New York City. The text of his speech can be found at the following link: <https://www.finra.org/newsroom/speeches/061616-remarks-sifma-complex-product-forum>.

Analogizing from a hypothetical menu of different options at a deluxe Parisian restaurant, Mr. Selman explained the potential difficulty that retail investors may have in understanding, selecting and comparing different complex financial products. The problem can be particularly significant where different contingencies may be difficult and time-consuming to value.

Different contingencies can render it challenging to compare products with different features. For example, an investor may value "principal protection" differently than "currency exchange risk." The problem can be exacerbated when a product involves multiple contingencies, such as, in Mr. Selman's example, a non-principal protected range accrual note in which both (a) the payment of interest depends upon the level of the applicable underlying asset at different times and (b) the payment at maturity may be less than par if the underlying asset decreases in value. The difficulty would be even more challenging in the case of a "worst of" structure that involves underlying assets with different risk profiles.

Mr. Selman's analysis is noteworthy in part because of its discussion not only as to how a financial advisor can advise an investor as to a single individual product, but how a financial advisor may potentially need to understand and explain multiple products, with different terms, features and underlying assets, when advising a client. He noted:

"To summarize these points, the complexity of a financial adviser's investment selection often will depend upon the answer to three questions:

- How many approved investment choices is the adviser expected to consider?
- How many of these investment choices have one or more embedded options?
- How many of these embedded options refer to reference assets that are unrelated to the essential features of the product?"

In the course of his discussion, Mr. Selman also reviewed some of FINRA's historic guidance as to what features would render a product "complex," and the need for financial advisors to understand products well enough to explain to investors their payoffs under different circumstances prior to offering them.

Mr. Selman also reminded the audience to be sensitive to the possibility that a financial services company might be issuing complex products to retail investors in order to manage its own risk. He noted, "[s]ome commenters have asserted that structured notes may be used as a mechanism to shift particular risks to retail investors. Such activity could present serious regulatory issues."

Mr. Selman reiterated FINRA's position that it is not necessarily questioning the utility of complex products. However, FINRA will continue to focus on the need for heightened training and supervision of financial advisors who do offer them.

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## More on Complex Products

At the SIFMA Complex Products Forum, attendees also benefitted from the views of Laura Posner, Bureau Chief of the Office of the New Jersey Attorney General, New Jersey Bureau of Securities, and Thomas Grogan, Senior Vice President, Deputy of Member Regulation Sales Practice, from FINRA. Ms. Posner and Mr. Grogan participated in a panel on complex products.

Mr. Grogan noted that FINRA Notice 12-03 subsumed FINRA's prior guidance, which had been contained in various notices to members, relating to complex products. Although he did not foreclose the possibility of new guidance on complex products generally, Mr. Grogan noted that the guidance in Notice 12-03 remained timely. Ms. Posner noted that the New Jersey Bureau of Securities remains focused on sales to retail investors of complex financial products, which may include a variety of products from variable annuities to structured products, to non-traded REITs and non-traded BDCs, to structured credit products.

Mr. Grogan noted that, in connection with its exams, FINRA will want to see materials relating to the member firm's vetting and approval process for new products. As part of the new product approval process, it is presumed that there will be a discussion of the risks and rewards of the proposed product, the investment thesis for the product, the intended audience for the product, the channels through which the product will be distributed, and training and other requirements related to product sales.

The panelists also discussed training and education for member firm registered representatives that sell complex products. Training is expected to be mandatory and to incorporate some means for assessing whether the registered representative understands the principal features of the product to a prospective client.

Both Mr. Grogan and Ms. Posner commented on sales of complex products to at-risk investors, especially senior citizens and others on fixed incomes. These investors may not understand the lack of liquidity associated with certain products or may not understand the multiple product features, how these may interact, and how these may affect product returns. Similarly, it was noted that there may be some "opaqueness" with respect to fees and potential conflicts of interest that may arise in connection with complex products. To that end, Mr. Grogan noted that FINRA had conducted a sweep on compensation related conflicts of interest. Ms. Posner highlighted NASAA's model fee disclosure for retail investors as providing a template for broker-dealers. The panelists also commented on concentration issues and trading in and out of complex products in customer accounts. They noted that broker-dealers generally have supervisory and oversight policies and procedures in place, which result in exception reports. Oftentimes, however, they noted that there was a lack of follow up once problematic practices had been identified through the use of the exception reports. They noted that during exams, this was a routine area of focus—that is, identifying the use of exception reports and noting the remedial actions taken by firms to the extent that the reports flagged problematic practices.

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## Investor Advisory Committee Recommends Proposals to the SEC to Enhance Information for Bond Market Investors

On June 7, 2016, the SEC's Investor Advisory Committee (the "Committee")<sup>4</sup> provided recommendations (the "Recommendations")<sup>5</sup> regarding certain proposals set forth in FINRA's Regulatory Notice 15-36 and the Municipal Securities Rulemaking Board ("MSRB") Regulatory Notice 2015-16.<sup>6</sup> The Recommendations reflect the SEC's ongoing efforts to enhance transparency in the market for fixed income securities.

FINRA Regulatory Notice 15-36 was released in October 2015 and set forth proposed rules for FINRA members to disclose additional information on customer confirmations, such as requiring them to disclose the bond price that the member paid, if the member acquired the security near in time to the resale, so an investor could see the markup or

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<sup>4</sup> The Committee was created under Section 911 of the Dodd Frank Act to advise the SEC as to a variety of regulatory issues.

<sup>5</sup> The Recommendations may be found at the following link: <https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-enhance-information-bond-market-investors-060716.pdf>.

<sup>6</sup> FINRA Regulatory Notice 15-36 may be found at the following link: [http://www.finra.org/sites/default/files/notice\\_doc\\_file\\_ref/Regulatory-Notice-15-36.pdf](http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-15-36.pdf).

MSRB Regulatory notice 2015-16 may be found at the following link: <http://www.msrb.org/~media/Files/Regulatory-Notices/RFCs/2015-16.ashx>

markdown on the customer confirmation.<sup>7</sup> The Recommendations advise the SEC to work with FINRA and MSRB to implement rules based on these proposals. The Recommendations further seek to provide enhanced disclosure of full transaction bond costs, enhanced access to material information prior to the investment decision and greater transparency in the bond market.

First, the Committee recommends that the SEC work with MSRB and FINRA to require dealers to provide more price information to retail investors regarding the transaction costs of purchasing or selling bonds on both an agency and principal basis.<sup>8</sup>

In the longer term, the Recommendations also ask the SEC to work with brokers, FINRA and the MSRB to provide full transaction cost information to investors *prior* to the purchase or sale of any bond. Brokers generally provide price and yield information to potential investors before a transaction occurs. The Recommendations would require that full transaction costs, including broker-dealer fees and commissions (“transaction costs”), be fully disclosed to potential investors with other bond-specific information prior to the transaction.

Finally, the Committee is recommending that the SEC work with the MSRB and FINRA to improve and enhance investor access and transparency regarding recent transactions in the bond market for municipal, agency and corporate bonds. Currently, the MSRB manages the Electronic Municipal Market Access (“EMMA”) website, which provides information on recent municipal bond transactions, but is not necessarily easy to navigate. Similarly, the Recommendations suggest that FINRA’s TRACE system could provide additional data to make it more useful to retail investors.

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## Brexit and Securities Offerings in the United Kingdom and European Union

In a recent alert, we discuss some initial thoughts on the potential impact of Brexit on issuers and distributors of securities in the context of the prospectus requirements that apply to offerings of securities in the United Kingdom and the European Union. Please review our alert:

<http://www.mofo.com/~media/Files/ClientAlert/2016/06/160629BrexitProspectusRequirements.pdf>.

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## The Federal Reserve’s Proposed Rules for Financial Contracts of Global Systemically Important Banking Organizations and ISDA’s Resolution Stay Jurisdictional Modular Protocol

Last month the Board of Governors of the Federal Reserve System (the “Board”) issued proposed new rules (the “Proposed Rules”) intended to reduce the potential risks posed to the U.S. financial system by too-big-to-fail banks.<sup>9</sup> The Proposed Rules would, among other things, require certain systemically important banks to include in their contracts provisions that would significantly limit their counterparties’ default rights in over-the-counter swaps, repurchase and reverse repurchase agreements, securities lending and borrowing transactions, commodity contracts, and forward agreements. The Proposed Rules, available [here](#), are open to public comment until August 5, 2016. Contemporaneously with the Board’s release of the Proposed Rules, the International Swaps and Derivatives Association, Inc. (“ISDA”) released its ISDA Resolution Stay Jurisdictional Modular Protocol (the “JM Protocol”) intended to permit market participants to comply with the Proposed Rules (when adopted in their final form) and similar rules of foreign jurisdictions. We discuss the Proposed Rules and the related ISDA protocols, which would affect all issuers of structured products, in this alert: <http://www.mofo.com/~media/Files/ClientAlert/2016/06/160629FedProposedRulesFinancialContracts.pdf>.

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<sup>7</sup> We discussed some aspects of the proposal in our November 4, 2015 issue of this publication, which may be found at the following link:

<http://www.mofo.com/~media/Files/Newsletter/2015/11/151104StructuredThoughts.pdf>.

<sup>8</sup> Under the current MSRB regime in Rule G-15, dealers are only required to disclose on the customer confirmation certain remuneration received from the customer when the dealer is acting as an agent. There is no comparable disclosure requirement under the SEC’s or MSRB’s rules when the dealer is acting as principal.

<sup>9</sup> Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 81 Fed. Reg. 29,169 (May 11, 2016).

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## Upcoming Events

### Brexit-Related Webinars

On June 23, 2016, the UK electorate voted narrowly in favor of the UK leaving the European Union. The result of this vote will have broad and wide reaching economic and political consequences, and a major impact on businesses with operations in the UK/EU or that issue securities in the EU or contract with EU parties. These programs will provide an overview and discussion of the possible effect of a so-called "Brexit" on EU issuances of securities and transactions in other financial instruments.

*Speakers:* Peter Green, Morrison & Foerster LLP and Jeremy Jennings-Mares, Morrison & Foerster LLP

### Brexit: Implications for Securities and Other Financial Transactions

*PLI Webinar*

Thursday, July 7, 2016 | 11:00 a.m. to 12:00 p.m. EDT

To register or for more information, [click here](#).

### The European Securities Regime pre and post-Brexit

*West LegalEdCenter Webinar*

Monday, July 18, 2016 | 12:00 p.m. to 1:00 p.m. EDT

To register or for more information, [click here](#).

### CD Programs and Structured CDs

*Morrison & Foerster Teleconference*

Thursday, July 14, 2016 | 11:00 a.m. to 12:30 p.m. EDT

In this session, we will discuss CDs and CD programs, including many of the unique issues that relate to structured CDs. In particular, we will focus on:

- the banking and securities law rules that govern these products;
- frequently recurring issues that arise in structuring and documenting them;
- practical advice for creating and managing CD programs; and
- current trends in offerings from CD programs.

*Speaker:* Lloyd Harmetz, Morrison & Foerster LLP

To register or for more information, [click here](#).

### Index Regulation and Outsourcing Index Administration

*Morrison & Foerster/Markit Master Class*

Thursday, July 28, 2016 | 8:30 a.m. – 9:30 a.m. EDT

Morrison & Foerster LLP

250 West 55th Street

New York, NY 10019

With the increased regulation of benchmark indices and index governance in Europe, market participants already are focused on compliance. Regulation and scrutiny likely will not be limited to indices that are true benchmarks, but may well also affect proprietary indices.

*Speakers:* Mark Schaedel, Markit and Lloyd Harmetz, Morrison & Foerster LLP

To register or for more information, [click here](#).

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### Join our *Structured Thoughts* LinkedIn Group

Morrison & Foerster has created a LinkedIn group, *StructuredThoughts*. The group will serve as a central resource for all things Structured Thoughts. We have posted back issues of the newsletter and, from time to time, will be disseminating news updates through the group.

To join our LinkedIn group, please [click here](#) and request to join or simply e-mail Carlos Juarez at [cjuarez@mofo.com](mailto:cjuarez@mofo.com).

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For more updates, follow Thinkingcapmarkets, our Twitter feed: [www.twitter.com/Thinkingcapmkt](http://www.twitter.com/Thinkingcapmkt).

**Morrison & Foerster was named the 2016 Equity Derivatives Law Firm of the Year at the EQDerivatives Global Equity & Volatility Derivatives Awards. Morrison & Foerster was named 2016 Americas Law Firm of the Year for the second year in a row by GlobalCapital for its Americas Derivatives Awards.**

Morrison & Foerster has been named Structured Products Firm of the Year, Americas by *Structured Products* magazine seven times in the last 11 years.

Morrison & Foerster was named Best Law Firm in the Americas, 2012, 2013, 2014 and 2015 by *Structured Retail Products.com*.

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#### About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life sciences companies. We've been included on *The American Lawyer's* A-List for 12 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at [www.mofo.com](http://www.mofo.com). © 2016 Morrison & Foerster LLP. All rights reserved.

*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*