

IS DELIVERY OF ETNS TO SETTLE SHORT SALES BY DEALERS WITHIN THE EXEMPTION FROM SEC REGISTRATION PROVIDED BY THE REGISTERED HEDGING NO-ACTION LETTER?

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The Securities and Exchange Commission (the “SEC”) Office of Capital Markets Trends has questioned whether short sales of exchange-traded notes (“ETNs”) by broker-dealers and the closing out of short positions by borrowing ETNs from the issuer or its affiliates, as disclosed in the ETN prospectus, were registered under Section 5 of the Securities Act of 1933 (the “Securities Act”). This raises an interesting question as to whether the principles established in the registered hedging letter¹ could be extended to cover short sales transaction in ETNs by dealers that are not affiliates of the ETN issuer. Issuers of ETNs should carefully review the plan of distribution sections of their ETN pro-

spectuses to ensure that there is no inference that an affiliated broker-dealer is executing short sale transactions in the ETNs.

Discussion

The plan of distribution section of the base prospectus in a shelf registration statement is drafted in a broad manner, designed to capture the many ways that the issuer might sell the subject securities. This is because any material change to that description would require a post-effective amendment to the registration statement, which may be costly. The section usually also includes a brief description of use of the subject securities in various hedging activities, including the delivery of the securities by dealers, which may include affiliated dealers of the issuer, to settle short sales. By disclosing the manner in which various future transactions in the securities may occur, those transactions would be considered registered under the Securities Act.

Prospectuses for ETNs include disclosure that dealers, including affiliates of the issuer, may resell securities they have purchased in a market-making transaction after the original offer and sale of the ETNs, or they may sell ETNs covered by the prospectus in short sale transactions. Dealers may also make short sales of the ETNs and may cover those short positions by borrowing ETNs from the issuer or its affiliates or by purchasing ETNs from the



issuer or its affiliates, subject to the obligation to repurchase such ETNs at a later date. The prospectus will disclose that, as a result of these activities, these dealers may be deemed to be statutory underwriters. The prospectus will also disclose that it will be deemed to cover any short sales of the ETNs by market participants who cover their short positions with ETNs borrowed or acquired from the issuer or its affiliates as described in the plan of distribution.

All was going swimmingly until the SEC's Office of Capital Markets Trends issued its sweep letter to a number of ETN issuers in February 2014 (the "Sweep Letter"). In the Sweep Letter, the SEC questioned whether short sale transactions disclosed in the ETN prospectus were registered under Section 5 of the Securities Act:

We note that in some offerings there is disclosure in the prospectus supplement stating that broker-dealers and other persons may make short sales of ETNs and may cover such short positions by borrowing ETNs from the issuer or its affiliates. In some cases the issuer has agreed to repurchase those ETNs. These activities may impact in the short or long term the number of ETNs outstanding at any point. Please disclose whether you intend to engage in such activities and if so how you will publicly disclose such loans and repurchases. *Please confirm you will register these transactions under the Securities Act of 1933.* If applicable, please provide risk factor disclosure that describes the market impact of short sales and the effect that securities lending may have on the number of ETNs outstanding at any time.

Sweep Letter, Item #13 (emphasis added).

It is believed that most ETN issuers responded to Item #13 of the Sweep Letter by noting that they did not engage in short sale transactions in the ETNs. The question left unanswered was why

the SEC believed that the existing disclosure regarding the potential use of ETNs to close out short sales did not constitute registration of those transactions.

Short Sales

The SEC defines a short sale as "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller."²

Short selling is a method used when the seller believes that a security will drop in price. For example, if the investor believes that issuer A's ETNs, which are trading at \$40 per ETN, are likely to decline in price, the investor will borrow ETNs (possibly from issuer A or its affiliates) and sell them at \$40 per ETN in a short sale. If all goes according to the investor's plan, when the ETN's trading price drops, let's say to \$20 per ETN, the investor will buy ETNs on the NYSE at \$20 per ETN and close out its short position by using the \$20 per ETN shares to replace the ETNs it borrowed at \$40 per ETN. The investor's profit would be \$20 per ETN, less costs. Of course, if the price of the ETN went up, instead of down, by the time the borrowed ETNs had to be replaced, the investor could lose money.

Registered Hedging

The SEC Staff issued no-action relief for hedging activity by counterparties to the issuer in the Registered Hedging Letter. Those activities included the closing out of short sales by the delivery of registered equity securities. In the Registered Hedging Letter, relief from the registration requirements of Section 5 of the Securities Act was requested for certain "dynamic hedg-

ing” transactions by an unaffiliated counterparty of the issuer.

The basic factual elements of the Registered Hedging Letter are these:

- An issuer registers a primary transaction of equity securities (“Shares”) on a shelf registration statement under Rule 415 under the Securities Act;
- A counterparty (in this case, Goldman, Sachs & Co. or one of its affiliates (“Goldman”)) (the “Counterparty”) enters into a derivative contract (a “Contract”) with the issuer, under which a maximum number of Shares is deliverable (the “Maximum Number of Shares”);
- At least the Maximum Number of Shares is registered under the Securities Act, and prospectuses are delivered in connection with the Counterparty’s sale of the Maximum Number of Shares;
- The Counterparty makes further sales of Shares (including short sales) in connection with its hedging activities (“Dynamic Hedging”), which sales are settled with unrestricted stock³ acquired otherwise than from the issuer; and
- Shares issued pursuant to a Contract or pledged or loaned by the issuer in connection with the Contract are delivered during the term of, or at the maturity of, a Contract, up to the Maximum Number of Shares, to close out open borrowings of stock created as a result of the Dynamic Hedging activities.

No prospectus would be delivered in connec-

tion with the Dynamic Hedging activities described in the last two bullet points above.

Counsel for Goldman made a number of representations in its no-action request. The registration statement would include the sample disclosure below in its plan of distribution, substantially in the following form (which is now in widespread use):

The Company may enter into derivative transactions with third parties, or sell securities not covered by this prospectus to third parties in privately negotiated transactions. If the applicable prospectus supplement so indicates, in connection with those derivatives, the third parties may sell securities covered by this prospectus and the applicable prospectus supplement, *including in short sale transactions*. If so, the third party may use securities pledged by the Company or borrowed from the Company or others to settle those sales or to close out any related open borrowings of stock, and may use securities received from the Company in settlement of those derivatives to close out any related open borrowings of stock. The third party in such sale transactions will be an underwriter and, if not identified in this prospectus, will be identified in the applicable prospectus supplement (or post-effective amendment).

Registered Hedging Letter at 4, n.4 (emphasis added).

Because the Dynamic Hedging sales and purchases of Shares by the Counterparty (after the initial sale of the Maximum Number of Shares pursuant to the issuer’s registration statement) would be independent of the terms of the Contract, and the issuer would have no economic interest in the Dynamic Hedging transactions, counsel took the position that the Dynamic Hedging transactions would be within the exemption from registration provided by either Section 4(a)(1) or 4(a)(3) of the Securities Act.

With respect to settlement of short sales, relief from the registration requirements of Section 5 of the Securities Act was requested for the delivery to close out any open borrowings of stock created in the course of the Dynamic Hedging activities of any Shares received by the Counterparty from the issuer upon settlement of the Contract, or Pledged Shares rehypothecated or borrowed or Loaned Shares borrowed by the Counterparty during the term of the Contract, not exceeding the Maximum Number of Shares.⁴

The SEC Staff responded that an exemption from registration otherwise available to the Counterparty would not be affected by the Counterparty's Dynamic Hedging activities in excess of the Maximum Number of Shares. As stated in the request letter, initial transactions in the Maximum Number of Shares would be registered, and prospectuses would be delivered in connection with those initial transactions.

With respect to the various settlements and closing out of open borrowings of stock (which includes the covering of short sale transactions with Shares), the SEC Staff took the position that no registration was required, and no prospectuses need be delivered, for the use of Shares delivered upon settlement of the Contract, Shares purchased in the open market in connection with the cash or net physical settlement of the Contract, or rehypothecated or borrowed Pledged or Loaned Shares, if the total of all such Shares did not exceed the Maximum Number of Shares, subject to the netting and replacement provisions described in the request letter.

Does the Registered Hedging Letter Apply to Short Sales of ETNs?

The Sweep Letter raised two concerns about

short sales, as described in a typical ETN prospectus: whether those sales are registered, and whether there is any effect on the market for the ETNs as a result of short sale covering activities.

With regard to the Sweep Letter's first concern, at best, the transactions described in the Registered Hedging Letter are analogous to a broker-dealer's use of ETNs to close out short positions in the ETN.

As discussed above, ETN prospectuses disclose the use of ETNs to close out short sales. Some of the plans of distribution in ETN prospectuses mention using ETNs in hedging transactions. Current ETN plan of distribution disclosures relating to short sale transactions are very close to the sample disclosure in note 4 of the Registered Hedging Letter.⁵ It is not known whether the hedging transactions in ETNs by dealers, including the settlement of short sales of ETNs, match exactly the description of Dynamic Hedging in the Registered Hedging Letter. It is also not known whether an exact match would be required for the SEC to view such short sales as within the relief provided by the Registered Hedging Letter. It is unlikely that a hedging contract relating to ETNs would exceed the maximum aggregate principal amount of ETNs covered by the prospectus.

Affiliated Dealers

Some ETN prospectus plan of distribution sections are not clear that the use of ETNs to cover short sales will be effected by an unaffiliated dealer, in contrast to the sample language plan of distribution disclosure included in the Registered Hedging Letter. In some cases this may raise the

possibility that a dealer that is an affiliate of the issuer may be using ETNs to cover short sales.

In the Registered Hedging Letter, the SEC Staff confirmed that an exemption from registration otherwise available for the Counterparty would not be affected, with respect to the Dynamic Hedging transactions, after the Maximum Number of Shares were sold. Counsel had argued that Section 4(a)(1) or 4(a)(3), as applicable, should be available.⁶ The Registered Hedging Letter did not contemplate that the Counterparty might be an affiliate of the issuer. In that case, Section 4(a)(3) would not be available and the availability of Section 4(a)(1) would be highly fact-specific.⁷ Dynamic Hedging transactions within the scope of the Registered Hedging Letter would have to be performed by a non-affiliated dealer. Consequently, ETN issuers should ensure that their Registered Hedging Letter-inspired disclosure does not suggest that an affiliate of the issuer is using ETNs to cover short positions.

Most prospectuses for ETNs contemplate a role for the broker-dealer that is affiliated with the issuer in market-making resales of the ETNs. The registration statements for an issuer with an affiliated broker-dealer usually include a footnote to the “Calculation of Registration Fee” table under which market-making resales of the securities are registered.⁸

Would the SEC view the registration of market-making resales by an affiliated broker-dealer as broad enough to cover that same affiliate’s Dynamic Hedging activities? The complexity of Dynamic Hedging transactions is entirely different than simply making a market for the ETNs.

Regulation M

Due to the constant creations of new ETNs, an ETN’s “restricted period,” for purposes of Regulation M, never ends. Issuers of ETNs redeem ETNs, and their affiliated dealers purchase ETNs in market-making transactions, during the ETN’s “restricted period.” Absent an exemption, or SEC no-action relief, redemptions by an ETN issuer or its affiliates would violate Rule 102 of Regulation M, and market-making transactions by broker-dealer affiliates of the ETN issuer would violate Rule 101 of Regulation M. Relief from the prohibitions on an issuer or a distribution participant bidding for, purchasing or attempting to purchase an ETN, in the form of redemptions by the issuer or market-making purchases by its affiliated dealer, was provided by the SEC Staff in the iPath no-action letter (the “iPath Letter”).⁹ One of the bases for the relief provided by the SEC Staff was that the ETNs were redeemable at the option of the holder on at least a weekly basis.¹⁰

The iPath Letter did not contemplate activities similar to Dynamic Hedging by distribution participants, such as a Counterparty, during the restricted period. However, due to the ability of ETN holders to redeem, and the activities of other market participants, such as arbitrageurs, to quickly buy or sell ETNs, any disparities between the trading prices of ETNs and the value of their underlying reference asset caused by short sales of ETNs should be eliminated. If faced with this fact pattern today, one would hope that the SEC’s Division of Trading and Markets would provide relief from Rules 101 and 102 of Regulation M for such activities, including covering short sales of ETNs, by an unaffiliated dealer.^{11, 12}

Effect on Trading Price

Prospectuses for ETNs are filed with a maximum aggregate principal amount of ETNs offered, even though a much smaller amount may actually be offered and sold at launch. Dealers sell ETNs to purchasers using newly created ETNs off of the prospectus, or by reselling ETNs bought from investors in market-making transactions. Once the maximum amount of ETNs is sold, and there are no more ETNs in inventory, the issuer must reopen the offering and amend the prospectus to reflect the new amount of ETNs that may be issued.¹³

If the use of ETNs to cover short sales caused the issuer to exceed the maximum aggregate principal amount of ETNs offered by means of the prospectus, a reopening would be in order. Market practice seems to indicate that an insignificant amount of ETNs are used to cover short sales. If an issuer does issue a significant amount of ETNs to cover short sales, it would be good practice to disclose that in the risk factor relating to the effect of supply and demand on the trading price of the ETNs.

Conclusion

Almost all shelf registration statements include Registered Hedging Letter-type disclosure in the supplemental plan of distribution. For the first time, the SEC has questioned whether that disclosure is sufficient to register the potential use of ETNs to cover short sales by dealers. On the one hand, the market is comfortable with using the Registered Hedging Letter-type disclosure to register those short sales. On the other hand, there are significant differences between the Registered Hedging Letter fact pattern and the use of ETNs to cover short sales. Those differences are magni-

fied if an affiliated dealer is executing the short sale transactions. At a minimum, given that the SEC has fired a warning shot, ETN issuers should revisit their disclosure to ensure that there is no inference that an affiliated dealer is involved in short sales of ETNs.

ENDNOTES:

¹Goldman, Sachs & Co. (Oct. 9, 2003) (the “Registered Hedging Letter”).

²Rule 200(a) of Regulation SHO.

³In the Registered Hedging Letter and in this article, “stock” refers to unrestricted securities of the issuer purchased in the open market, rather than the Shares issued under the registration statement.

⁴“Pledged Shares” are Shares pledged by the issuer (up to the Maximum Number of Shares) in order to secure the Share delivery obligation under the Contract. “Loaned Shares” are Shares loaned by the issuer to the Counterparty (up to the Maximum Number of Shares) during the term of the Contract.

⁵As mentioned above, disclosure similar to that in note 4 of the Registered Hedging Letter is commonplace now, whether or not the prospectus covers the issuance of ETNs or other securities.

⁶Section 4(a)(1) of the Securities Act, the ordinary trading exemption, is an exemption from registration for “[t]ransactions by any person other than an issuer, underwriter, or dealer.” Section 4(a)(3) provides an exemption from registration for certain transactions by dealers.

⁷The SEC does not view the exemption provided by Section 4(a)(3) to be available for resales by a dealer of the securities of an affiliated issuer. The SEC’s view is that this type of dealer is not within the definition of “dealer” in Section 2(a)(12) of the Securities Act, because it is not selling the securities of “another person.” If an issuer and its broker-dealer are affiliated,

the broker-dealer would be considered to be an issuer. See generally SEC Release 33-7606A (Nov. 13, 1998) at nn. 132-137 and accompanying text. If the Counterparty was not a dealer, but was an affiliate of the issuer, Section 4(a)(1) could be available for the Counterparty. However, if the Dynamic Hedging transactions were to be viewed as a distribution of the affiliated issuer's securities, then the Counterparty could be viewed as an underwriter and would then have to avail itself of Rule 144, which would be unworkable for this type of transaction.

⁸Section 4(a)(3) is not available to a broker-dealer engaging in market-making transactions in an affiliated issuer's securities. See note 8 above.

⁹Barclays Bank PLC (July 27, 2006).

¹⁰Almost all current ETNs are redeemable at the option of the holder on a daily basis. In the iPath Letter, counsel to the issuer represented that because the ETNs would be listed, thereby providing liquidity, and that the ETNs were redeem-

able, any significant disparity between the market price of the ETNs and their underlying value caused by issuer redemptions or market-making purchases by the issuer's affiliated broker-dealer should be eliminated by arbitrage activity.

¹¹In the Registered Hedging Letter, the Shares were "actively traded" within the meaning of Rule 101(c)(1) of Regulation M, thus providing an exemption for effecting purchases of securities of the same class of the Shares during any restricted period. ETN issuers and their affiliated dealers rely on the iPath Letter for relief from Rules 101 and 102 of Regulation M.

¹²The Division of Trading and Markets was aware that there would be short sales of the ETNs discussed in the iPath Letter, as relief was requested from Rule 200(g) of Regulation SHO. See the iPath Letter at III.(d).

¹³During this continuous distribution, ETNs redeemed by investors are cancelled, thus decreasing the available inventory of ETNs.

