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STRUCTURED THOUGHTS

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FINRA'S PROPOSED AMENDMENTS TO THE CORPORATE FINANCING RULE – IMPACT ON STRUCTURED NOTE OFFERINGS

On April 11, 2019, FINRA filed with the SEC a diverse set of proposed revisions to Rule 5110, its Corporate Financing Rule. The proposed amendments would impact a variety of types of offerings. In this article, we discuss the anticipated impact on issuances of structured notes.

The full text of the rule proposal can be found at the following link: https://www.finra.org/industry/rule-filings/sr-finra-2019-012[1]

The proposal reflects FINRA's previous proposed amendments, discussed in Regulatory Notice 17-15, but also reflects a variety of changes based on comments from market participants.[2]

[1] Public service note: We advise you to exercise caution in printing the full file. If you do so, consider checking that your printer is fully loaded with paper.
[2] Regulatory Notice 17-15 may be found at the following link: http://www.finra.org/industry/notices/17-15

FILING REQUIREMENTS

Most issuers of structured notes in the U.S. find an exemption from filing their registration statements and related documents with FNIRA. The exemption typically relied upon is Rule 5110(b)(7)(C)(i), which exempts offerings:

- that are registered on SEC Forms S-3 and F-3 under the eligibility standards for those forms that were in effect before October 21, 1992; and
- that are registered in a shelf offering.

The proposed amendments would clarify and, to some extent, modernize this exemption by creating a new definition of an issuer that would be exempt from the filing requirements. For this purpose, an "experienced issuer" would be an issuer that:

- has a 36-month reporting history with the SEC, and a public float of at least $150 million; or
- has voting stock held by non-affiliates with an aggregate market value of at least $100 million, and the issuer has an annual trading volume of three million shares or more in the stock.

Due to their size, most issuers of structured notes will be unaffected by this proposed amendment.

The proposed amendments would also clarify that securities of banks[3] that have qualifying outstanding investment-grade securities would be exempt from the filing requirements. Under this exemption, issuers that have unsecured non-convertible debt with a term of at least four years that are investment-grade securities are exempt from the requirement to file with FINRA under the rule.

The proposed amendments explicitly exclude Rule 144A offerings and Regulation S offerings from the definition of "public offerings" that are subject to the rule and its filing requirements.

DISCLOSURE REQUIREMENTS

FINRA's Corporate Financing Rule and the SEC's Regulation S-K disclosure documents work together to some extent, and impact the disclosures in offering documents for structured notes. Accordingly, practitioners have traditionally been mindful of the Corporate Financing Rule's definitions of underwriting compensation and the calculation of the relevant amounts. These items typically must be set forth in the relevant prospectus.

In Notice 15-17, FINRA had originally contemplated revising these rules so that the dollar amount ascribed to each individual item of compensation would not need to be disclosed (other than the underwriting discount and commission, which would need to be separately disclosed). Instead, under the original proposal, the maximum aggregate amount of all underwriting compensation would be disclosed on the cover page of the prospectus. FINRA's proposal does not contemplate removing the disclosure requirement as to the individual elements of compensation. Accordingly, for structured note offerings where the underwriters receive compensation in different forms, itemized disclosure will continue to be needed.

TREATMENT OF DERIVATIVES

The proposed rule change attempts to clarify the treatment of derivatives issued in connection with public offerings, including those that are created in structured note offerings. The proposed rule change would expressly provide that derivative s acquired in a transaction *unrelated* to a public offering would *not* be underwriting compensation. (Accordingly, there would be no valuation-related requirements for these instruments.)

In contrast, derivatives acquired in a transaction that *is* related to a public offering (as is the case for most structured note offerings) *would be* underwriting compensation.

For an instrument that is subject to underwriting compensation, the proposed rule change would clarify that (for offerings that must be filed with FINRA):

- a description of the derivative instruments must be filed with FINRA; and
- the description must be accompanied by a representation that a registered principal or senior manager of the participating FINRA member has determined whether the transaction was or will be entered into at a "fair price."[4]

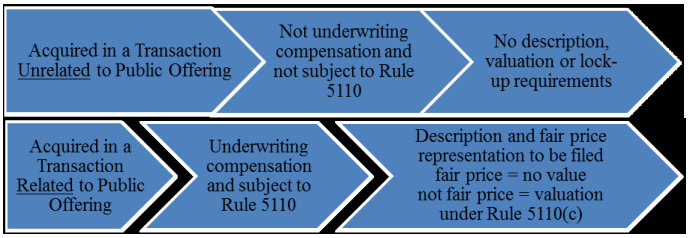
The proposed rule change would also clarify that the valuation of a derivative depends upon whether it was or was not acquired at a fair price. Specifically, the proposed rule change would clarify that a derivative instrument

[3] For the avoidance of doubt, this exemption relates to banks themselves, and not, for example, bank holding companies. Banks may offer structured notes that are exempt from SEC registration under Section 3(a)(2) of the Securities Act of 1933.

[4] The proposed rules would define the term "fair price" to mean that the FINRA member has priced the derivative instrument in good faith; on an arm's-length, commercially reasonable basis; and in accordance with pricing methods and models and procedures used in the ordinary course of its business for pricing similar transactions. This definition is important not only as to the filing requirement, but also due to the disclosure and lock-up discussion that follows.

acquired at a fair price would be considered "underwriting compensation," but would have *no compensation value*. Accordingly, there would be no specific compensation value to disclose in a structured note prospectus.[5] In contrast, the proposed rule change would provide that derivatives not acquired at a fair price *would be* considered underwriting compensation, and subject to the normal valuation requirements of the rule. In such a case, the disclosure of the relevant amount would be required disclosure. Of course, issuers would need to be careful in calculating these amounts, due to the potential for liability if the disclosed amount is misleading in some way.

The rule proposal provides the following helpful flowcharts as to these issues, which we couldn't resist the temptation to reproduce here:



DERIVATIVES AND THE CORPORATE FINANCING RULE'S LOCK-UP PROVISIONS

The proposed rules explicitly provide that the lock-up requirements of the Corporate Financing Rule would not apply to derivatives that are related to a public offering, and that are entered into at a fair price. Of course, due to a hedge provider's need to adjust its position from time to time, this factor increases the stakes for the member to exercise caution when pricing these instruments to the structured note issuer.

EFFECTIVE DATE

FINRA's re-proposal remains subject to a 21-day public comment period. Accordingly, the proposal remains subject to further change, and an effective date is not yet known. That being said, to the extent that FINRA's prior proposal was subject to somewhat significant commentary, which was reflected in the re-proposal, we anticipate that FINRA will endeavor to have a finalized set of rule changes in the not-so-distant future.

[5] That being said, it is possible that some issuers and underwriters will seek to disclose this information, in an effort to convey information that may be of interest to some investors and/or distributors.

SEC RULE AMENDMENTS ADD NEW ANNUAL REPORT EXHIBIT REQUIREMENT

INTRODUCTION

In March 2019, the SEC enacted several amendments to its disclosure requirements under Regulation S-K and related rules. These amendments were adopted under a directive to the SEC from the 2015 Fixing America's Surface Transportation Act (the "FAST Act").[6]

For our firm's more complete discussion of these amendments, please see the following link: https://www.mofo.com/resources/publications/190411-sec-adopts-fast-act-amendments.html

Most of these rule changes do not have a significant impact on structured note offerings, in and of themselves. However, the SEC's changes to its exhibit rules for annual reports on Form 10-K (and for foreign issuers, Form 20-F) will create a new exhibit requirement that relates to these issuances, and will create an ongoing disclosure requirement.

DESCRIPTION OF DEBT SECURITIES

The Item 202 of Regulation S-K currently requires issuer conducting an offering of debt securities, including structured notes, to provide a description of these debt securities in the applicable prospectus.[7] However, under the SEC's current rules, this disclosure is not required in the issuer's ongoing reports on Form 10-Q or Form 10-K. Under the SEC's amendments to Item 601 of Regulation S-K, issuers will now be required to provide the information required by Item 202(a)-(d) and (f) (setting forth the material terms of the relevant securities) as an exhibit to their annual report on Form 10-K. The SEC adopted comparable amendments to Form 20-F to align the requirements of that form for non-U.S. issuers. In adopting these amendments, the SEC indicated that its goal was to make this information more accessible to investors.

The new requirement applies solely to debt securities that are registered under the Securities Exchange Act of 1934 (the "1934 Act"). Accordingly, even though they are

[6] The SEC's rule release may be found at the following link: https://www.sec.gov/rules/final/2019/33-10618.pdf. This is another document to exercise caution in printing, due to its length.

[7] In structured note offering documents, this discussion is typically spread between several documents, which may include a base prospectus, MTN prospectus supplement, pricing supplement, and if applicable, a product supplement.

publicly offered, many or most structured note issuances will not be subject to the exhibit requirement. Similarly, unregistered bank note offerings, Rule 144A offerings, Regulation S securities, and structured CDs will not be subject to the requirement.

For issuers such as financial institutions, which have a significant number of these debt securities, including structured notes, this will result in a somewhat long exhibit. For example, all ETN offerings, which are registered under the 1934 Act in order to list on an exchange, will be subject to the exhibit requirement. Similarly, a number of finance subsidiaries were organized around 2016 under the Federal Reserve's TLAC rules, and registered a class of debt securities under the 1934 Act for "blue sky" purposes; these issuances will be subject to the exhibit requirement.

In many cases, the content of this exhibit can largely be copied from the "Description of the Notes" section that was used in the relevant prospectus. Of course, for some types of securities, the drafting will be a little more complicated – for example, in some cases, the key terms of a structured note appear in several different portions of the offering documents: the cover page, the summary section, and (of course) the "Description of the Notes" (together with the underlying documents mentioned in footnote 7 above).

The new exhibit requirement will apply to U.S. issuers that file Form 10-K, and to non-U.S. issuers that file Form 20-F. However, Canadian issuers, which file annual reports under the MJDS on Form 40-F, will not face a comparable requirement.

Under new Instruction 601 to paragraph (b)(4)(vi), the issuer may incorporate by reference the required disclosures to an exhibit previously filed in satisfaction of the new disclosure requirement, as long as there has not been any significant change to the relevant information. However, for issuers that are frequently in the market, annual updates to each year's exhibit will certainly be needed.

IMPACT OF THE RULE AMENDMENT

Generally speaking, the SEC's rule-making under the FAST Act has been designed to simply the SEC's disclosure requirements, and to remove unnecessary or duplicative disclosure requirements. In this case, the new exhibit requirement adds to issuer disclosure requirements, through the new annual exhibit requirement. For some types of securities, this exhibit may not be very useful for investors. First, it is not obvious that interested investors should look to the exhibits to an annual report for this type of information; most investors have been comfortable to date obtaining the relevant information from the pricing supplements that are already filed on the SEC's EDGAR system. In addition, for a variety of products, such as exchange-traded notes, many issuers maintain a user-friendly website, where the relevant offering documents can be readily obtained.

EFFECTIVE DATE

This feature of the new rules will be effective on May 2, 2019. Accordingly, for most issuers, it will apply to the first annual report they file in calendar year 2020. For issuances that are subject to the exhibit requirement, it will be useful for the issuer and its counsel to track them, and the relevant parts of the offering documents that will be subject to the exhibit. Doing so will help prepare for more efficient and convenient drafting of the new exhibit.

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