

# Structured Thoughts

*News for the financial services community.*



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## EU Regulation on Short Selling: Impact on U.S. Issuers of Structured Notes

On November 1, 2012, the regulation (the “**Regulation**”)<sup>1</sup> of the European Parliament and Council of the European Union on short selling and certain aspects of credit default swaps became effective.<sup>2</sup> The Regulation may have a substantive impact on U.S. issuers of structured products linked to securities that trade in the European Union, as well as other participants in structured product transactions, and this article is intended to discuss some of these impacts.

The Regulation was conceived out of the need to harmonize the fragmented approach of different regulators throughout the EU towards restricting short selling and the use of credit default swaps (“**CDS**”), which limits the effectiveness of adopted measures and results in regulatory arbitrage. The Regulation seeks, in particular, to improve the transparency related to significant short positions and address risks of negative price spirals and settlement failures, especially in relation to uncovered or ‘naked’ short selling. Although the issuance of structured products does not necessarily relate to these issues, structured product transactions are among the transaction types impacted by the Regulation.

### Scope of the Regulation and Key Provisions

The Regulation has been broadly drafted to include the short selling of equity securities admitted to trading on an EU regulated market or a multilateral trading facility, certain types of EU sovereign debt<sup>3</sup> (as well as derivatives and structured

<sup>1</sup> The Regulation may be found at the following link: <http://register.consilium.europa.eu/pdf/en/11/pe00/pe00068.en11.pdf>.

<sup>2</sup> For our firm’s summary of the Regulation, please see our client alert, which may be found at the following link: <http://www.mofo.com/files/Uploads/Images/120327-European-Council-Regulation-Short-Selling-Credit-Default-Swaps.pdf>.

<sup>3</sup> To be covered by the Regulation, the sovereign debt must be issued by (i) the EU, (ii) a member state (including a government department, an agency or a special purpose vehicle (“**SPV**”) of the member state), (iii) a federal member state, (iv) an SPV for several member states, (v) an international financial institution established by two or more member states, or (vi) the European Investment Bank.

product transactions referencing and providing exposure to these securities) and the buying of credit protection through CDS in relation to EU sovereign debt. As a result, structured products that reference relevant securities will potentially be affected by the Regulation.

The Regulation creates a two-tier disclosure regime of public and private disclosure of net short positions in relation to equity securities. The Regulation also introduces disclosure requirements for the shorting of EU sovereign debt and trading in naked sovereign CDS. Structured products linked to sovereign debt tend to be limited to the institutional market in the U.S.

The Regulation requires market participants to effect (by 3:30pm on the following trading day) a private notification of a net short position, calculated at midnight in the relevant EU member state at end of a trading day on which its net short position reaches or falls below 0.2% of the relevant issuer's issued share capital, and each 0.1% above that, up until 0.5%. A public notification must be made when the relevant entity's net short position at midnight in the relevant EU member state at end of a trading day reaches or falls below 0.5% of the applicable company's issued share capital, and each 0.1% above that.

The calculation of net short positions is required to take into account all long and short positions which the holder has in relation to the relevant shares or EU sovereign debt, as well as any other form of economic interest in those instruments. In particular, it is required to take into account interests obtained directly or indirectly through the use of derivatives (including options, futures and contracts for differences) and indices, baskets of securities and exchange traded funds.

In determining net short positions in relation to EU sovereign debt, a disclosing entity is also required to take into account its positions under CDS trades relating to the relevant EU sovereign debt issuer. Disclosure need only be made to the national regulator of the relevant sovereign issuer. There is no equivalent public disclosure requirement and the notification thresholds vary by member state.<sup>4</sup> However, uncovered EU sovereign CDS entered into on or after March 25, 2012 are no longer permitted. Those trades entered into prior to March 25, 2012 may be held until the maturity date of the contract.

For purposes of the Regulation, it does not matter when the trade creating a particular long or short position was effected. An issuer's only concern is whether it has an open net short position on or after November 1, 2012. It is also worth bearing in mind that the Regulation allows any existing member state rules relating to short selling to remain in place until July 1, 2013. As such, it is important (for now) to be aware of any local member state rules which may apply in addition to the Regulation.

The Regulation also obliges holders of short positions to keep for five years records of their net short positions, as well as the gross positions supporting these net short positions. However, the requirement to identify short sales in (private) transaction reports to competent authorities, which was in previous versions of the Regulation text, has been deferred to the Commission in its consideration of amendments to the Markets in Financial Instruments Directive 2004/39/EC.

The Regulation applies to parties anywhere in the world, regardless of their jurisdiction of organization or operations. The Regulation also applies to transactions that are effected within or outside of Europe.

The Regulation does not apply to shares for which the principal trading venue is outside the EU. As a result, for example, a French company that has its primary market in Paris, but also trades to a lesser degree in ADRs on the New York Stock Exchange will be covered. In contrast, a U.S. company that has its primary market in the U.S., but also has some trading on the London Stock Exchange, will not be subject to the Regulation.

### **Types of Transactions Impacted: Issuers**

A variety of typical U.S. structured note transactions will be subject to the Regulation.

For example, a U.S. issuer issues a registered structured note linked to the positive performance of the NYSE ADRs of a French company traded in Paris. The issuance of the note creates a "net short position" for the issuer. If the U.S. issuer

<sup>4</sup> Individual member country notification thresholds can be found at: [www.esma.europa.eu/page/Net-short-position-notification-thresholds-sovereign-issuers](http://www.esma.europa.eu/page/Net-short-position-notification-thresholds-sovereign-issuers).

enters into a corresponding swap transaction with an unrelated third party through which it passes along all of its exposure to the upside performance of the ADRs, the net short position will revert to zero. On the other hand, if it enters into the same swap transaction with an affiliated entity, the corporate group as a whole will retain that net short position. Of course, it's entirely possible that the related-party entity will offset some or all of its exposure to the ADRs through one or more transactions with other entities, and reduce the net short position.

Similar results arise from linking to an index or an exchange-traded fund that includes European securities. For example, the EURO STOXX 50 Index and the MSCI EAFE Index (and ETFs that track those indices) are common underlying assets for U.S. structured notes. As to each relevant European security within the index or ETF, the Regulation requires the issuer to recognize a portion of the principal amount of each relevant structured note as a short position in the relevant security, according to its weighting in the index or ETF.

### Types of Transactions Impacted: Investors

Investors, particularly institutional investors, may enter into transactions that are regulated by the rules. For example, an investor with a particular market view may purchase a note that is linked to the *negative* performance of a particular stock or index. If the transaction is large enough, it can trigger the provisions of the Regulation. On the other hand, investing in a structured product that is bullish on a particular stock may offset a net short position that the investor otherwise may have.

### Compliance Efforts

Needless to say, the Regulation creates a substantial compliance challenge for multi-national market participants. At any one time, these entities will have (whether directly, or through their affiliates) a wide variety of long and short positions in a large number of European stocks, and indices and ETFs that include European stocks. In some cases, the short position will arise from their issuance of a structured product. In other cases, the short position may arise due to its involvement in the hedging transactions for another issuer's structured products. These types of transactions need to be evaluated together with the myriad of transactions outside of the structured products world that the issuer may be undertaking. It seems inevitable that there will need to be new compliance units established (to the extent that this has not been done already) in order to track and match long and short positions across an institution's various affiliates and subsidiaries. This will likely be the case with respect to global institutions with multiple affiliates and branches and, to a lesser extent, institutions with narrower trading strategies (such as hedge funds).

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## Focus on Conflicts

In a recent issue of this newsletter,<sup>5</sup> we noted that FINRA representatives were focused on conflicts of interest in relation to the structuring and sales of structured products. In the period since that speech by Susan Axelrod, Executive Vice President, Member Regulation Sales Practice, of FINRA, the focus on conflicts seems to have intensified. In a more recent speech delivered at the end of October,<sup>6</sup> Axelrod emphasized that, in connection with the FINRA examination process, FINRA would continue to devote substantial attention to complex products offered to retail investors. She cited as examples principal-protected notes, non-traded REITs, reverse convertible notes, and other structured notes. In relation to complex products she advised that "Firms should also consider whether they have any conflicts—particularly where they maintain affiliations with the product issuer or where there is a compensation arrangement that creates a conflict." She also noted that firms should "identify potential conflicts and document their process for ensuring that they do not place their interest—or that of their brokers—before the clients."

Many of these same issues were raised in a presentation given by Carlo di Florio, Director of the SEC's Office of Compliance Inspections and Examinations.<sup>7</sup> Di Florio highlighted conflicts of interest as a key area in connection with OCIE examinations. Di Florio identified a number of types of conflicts that are high priorities in connection with

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<sup>5</sup> See <http://www.mofo.com/files/Uploads/Images/121001-Structured-Thoughts.pdf>.

<sup>6</sup> See <http://www.finra.org/Newsroom/Speeches/Axelrod/P193917>.

<sup>7</sup> See <http://www.sec.gov/news/speech/2012/spch103112cxd.htm>.

examinations. In this list, he included: “retail customers’ interests potentially taking a back seat to various financial incentives of a broker-dealer or its representatives in recommendations and sales practices for new or risky products. This includes, for example, the retailization of complex instruments such as structured securities products...”

Structured product offering documents and marketing materials generally disclose the role of any affiliated parties in the transaction, and highlight the risk of potential or actual conflicts of interest as a result of these relationships. Likewise, the disclosures generally alert potential investors that the issuer’s affiliated broker-dealer may be providing hedging arrangements to the issuer in connection with the note and/or engaging in hedging activities for its own account or in connection with other business activities. Participants in the structured products market may consider reviewing whether their internal sales and training materials also highlight these potential conflicts of interest. In connection with reviewing their policies and procedures to address FINRA Notice 12-03 on Complex Products, market participants also may want to ensure that their new product committees are charged with considering any actual or potential conflicts of interest that may arise in connection with “manufacturing” the product, entering into hedging arrangements related to the products, or distributing the products. Market participants also may want to evaluate whether it is appropriate to evaluate the terms of their various distributor arrangements, to the extent that these are significant, in connection with a review of potential conflicts of interest. As we highlighted in another recent issue, firms also may want to review their “window-cleaning” and other internal wall or information handling policies in relation to the manufacturing of structured products.

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## Revised FINRA Communications Rules: A Summary Table for Market Participants

As we approach the end of the year, and begin to plan for 2013, we remind readers that the effective date of FINRA’s new offering communications rules is February 4, 2013.<sup>8</sup> Accordingly, to help practitioners review the relevant requirements, and to help facilitate planning, set forth below is a table that summarizes the new requirements.

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<sup>8</sup> For additional information relating to the new rules, please see our Structured Products, Volume 3, Issue 9: <http://www.mofo.com/files/Uploads/Images/120621-Structured-Thoughts.pdf>.

## FINRA Communications Rules

Type of Communication	Principal Pre-Use Approval	FINRA Filing	Record-Keeping
Institutional Communication <sup>9</sup>	Written procedures must address education, training regarding communications	Not required to be filed	Three years from date of last use; Keep on file: name of preparer, copy of communication, source of statistical information or illustration, date of first and last use, and if principal did review, then name and date of approval
Retail communication <sup>10</sup>	<p>Requires approval before earlier of: use or filing with FINRA.</p> <p>Principal registration of approver will depend on type of material</p> <p><u>Exceptions:</u> Pre-approval is not required for:</p> <p><i>Previously Filed Materials:</i> (1) another firm filed it with FINRA and has received a review letter from FINRA, and (2) firm using it has not made material changes and will not use in a manner inconsistent with the FINRA letter;</p>	<p>For new members, 10 business days prior to first use: any retail communication published or used broadly. FWPs filed with SEC may be filed within 10 days of first use</p> <p>Within 10 business days of first use or publication: template for written reports re an investment analysis tool, a communication concerning an SEC-registered structured product,<sup>11</sup> a TV or video segment</p>	Three years from date of last use. File must include: (1) copy of communication, (2) date of first use, (3) date of last use, (4) name of principal who approved, (5) date approval received, (6) if pre-approval not required because another firm filed it, name of firm and their FINRA review letter, (7) source of any statistical information or illustration
	<i>Communications excluded from research report definition and that does not include any investment recommendation;</i>	<p>Exceptions to Filing Requirement:</p> <p>1) communications previously filed, to be used without material</p>	

<sup>9</sup> Institutional communication:

- written/electronic communications distributed or made available only to institutional investors
- does not include internal communications
- if member has “reason to believe” communication will be forwarded to retail investors, communication may be a “retail communication”

<sup>10</sup> Retail communication:

- any written/electronic communication distributed or made available to more than 25 retail investors within a 30-day period
- generally includes advertisements, sales literature, reprints
- sales scripts intended for use with retail customers

<sup>11</sup> New 2210(c)(3)(E) includes retail communications concerning any SEC-registered security derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a currency.

## FINRA Communications Rules

Type of Communication	Principal Pre-Use Approval	FINRA Filing	Record-Keeping
	<p><i>Materials posted in an online forum; and</i></p> <p><i>Any other communication that does not include an investment recommendation</i></p>	<p>change</p> <p>2) communications based on template previously filed (that will include updated statistical or changes to non-narrative info)</p> <p>3) materials that do not include a recommendation or promote a product</p> <p>4) communications that only identify an exchange symbol or a security for which the member is a market maker or offer a specific security at a price</p> <p>5) a prospectus or preliminary prospectus filed with SEC, or exempt from registration, EXCEPT that an FWP filed with SEC pursuant to rule 433(d)(1)(ii) is not considered a prospectus<sup>12</sup></p> <p>6) communications prepared in accordance with '33 Act Sec. 2(a)(10)(b), like rule 134 notices</p> <p>7) press releases available only to media</p> <p>8) reprints of published articles provided</p> <p>(a) member is not affiliated with publisher,</p> <p>(b) member or issuer or underwriter of any security mentioned has not commissioned,</p>	

<sup>12</sup> FWPs filed by an underwriter under Rule 433(d)(1)(ii) in a manner that will result in broad unrestricted distribution must be filed with FINRA, such as brochures posted on a public site, publicly available website pages about structured products.

## FINRA Communications Rules

Type of Communication	Principal Pre-Use Approval	FINRA Filing	Record-Keeping
		(c) member hasn't altered contents 9) correspondence 10) institutional communications 11) material posted on an online forum	
Correspondence <sup>13</sup>	Firm shall establish reasonable supervisory review process as required by Rule 3010.	Not required to be filed	Record retention requirements set out in Rule 3010.

### SUMMARY

#### SUBJECT TO FILING:

- FWP's that are red herrings (filed under Rule 433(d)(1)(ii) if distributed broadly, on an unrestricted basis ("underwriter FWP's"))
- If used broadly or on an unrestricted site:
  - a brochure
  - a product description
  - website product discussions
  - preliminary term sheets

#### NOT SUBJECT TO FILING:

- Preliminary Pricing Supplements (424(b) filings)
- Final Pricing Supplements (424(b) filings)
- Documents for certificates of deposit, bank notes, or 144A issuances
- FWP's that are final term sheets, filed with the SEC

<sup>13</sup> Correspondence: any written/electronic communication distributed or made available to 25 or fewer retail investors within a 30-day period.

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## StructuredRetailProducts.com: The Blog

StructuredRetailProducts.com, a leading online resource for structured products, recently launched a blog. The blog is intended to be a platform where industry leaders can share thought leadership, articles, knowledge and opinions about structured products. Posts cover many topics, including complex products, market transparency, regulatory issues, broker-dealers, indices and even relevant structured product trade conferences. To read the blog, visit [www.structuredretailproducts.com/blog](http://www.structuredretailproducts.com/blog).

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

Morrison & Foerster named **Structured Products Firm of the Year, Americas, 2012** by *Structured Products* magazine for the fifth time in the last seven years. See the write up at <http://www.mofo.com/files/Uploads/Images/120530-Americas-Awards.pdf>.

Morrison & Foerster named **Best Law Firm of the Americas, 2012** by *StructuredRetailProducts.com*.

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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 nine 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). © 2012 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.*