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Structured Thoughts

News for the financial services community.

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Structured Product Red Herrings: Rule 433 and Rule 424(b)

Red herrings for most offerings of structured products registered with the Securities and Exchange Commission (the "SEC") under the Securities Act of 1933, as amended (the "Securities Act"), are usually prepared and filed in one of two ways:

- Preliminary pricing supplements ("PPSs"), which are filed with the SEC under Rule 424(b) under the Securities Act; or
- "Free writing prospectuses," which are filed with the SEC under Rule 433.

This article explains the difference between these two, and describes some of the reasons why market practice varies as to their use.

Preliminary Pricing Supplements – Rule 424(b)

Once upon a time, when most of our readers were very young (that is, before December 1, 2005), there was no such thing as a "free writing prospectus." Any written offering document, subject to very limited exceptions, had to be in the form of a statutory prospectus. For purposes of a "red herring," or PPS, the SEC rules permitted a limited amount of pricing-dependent information to be omitted, e.g., principal amount, final interest rate, etc.

Needless to say, PPSs are long and detailed (especially when attached to an issuer's MTN prospectus supplement, supplementing the issuer's base prospectus). In addition, these documents are not necessarily presented in a manner that is useful to all investors.

Free Writing Prospectuses – Rule 433

In 2005, the SEC introduced “Securities Offering Reform” and related rules, which permitted the use of a wide range of written materials relating to structured notes and other offerings, in addition to the statutory prospectus.[1] Structured products professionals at first viewed the rule as a useful basis for creating brochures, term sheets and other materials that could help explain structured products more efficiently. However, many market participants quickly realized that, particularly when investors are familiar with the relevant issuer and the product class, a red herring could be issued in this manner. Especially when hyperlinks to the issuer’s base prospectus and prospectus supplement are added, the “styling” of a red herring as an FWP enables broker-dealers to provide a slimmer and a more convenient document for conveying the preliminary terms of an offering to investors.

Of course, in addition to their potential use as a preliminary offering document, FWPs can be used to summarize the terms of an offering, or to provide additional information that may be useful to investors. However, in this article, we will focus on the use of FWPs as a substitute for traditional PPSs.

How is a PPS Different from an FWP?

In practice, an FWP and a PPS need not be very different.[2] However, there are a few items that we should point out.

SEC Filing Requirement. Under Rule 433, an FWP must be filed with the SEC by 10:00 p.m. Eastern time on the date of first use. In contrast, under Rule 424(b), a PPS must be filed within two business days of its first use. In practice, a number of distributors will want the FWP or the PPS filed as soon as possible with the SEC, even if the SEC rules permit a “delay” of two business days for a PPS. For example, these distributors may use the links to the documents on the SEC website as one of the means by which they disseminate information about the offering to investors or to their own financial advisors. In addition, depending upon the suite of relevant offering documentation, the link to the red herring may also need to be included in other FWPs relating to the offering. Accordingly, timing may be of the essence for the filing of both FWPs and PPSs.

To many, the different timing requirements, that is, the “same day” requirement of Rule 433, as compared to the “two business day” requirement of Rule 424(b), is not particularly intuitive, especially when both documents are used for a comparable purpose. However, the invention of the FWP in 2005 was a relatively significant step for the SEC in 2005, and accordingly, the same-day filing requirement was in part designed to help ensure that offerees could obtain the benefit of any material information that is set forth in an FWP. It is not clear that the SEC anticipated that FWPs would be used as a substitute for a more traditional PPS.

Rule 433 Legend. An FWP (but not a PPS) must include a legend required by Rule 433, which refers to the issuer’s prospectus that has been filed with the SEC, and provides a toll-free number by which an investor can obtain that document.[3]

Attaching Base Prospectuses. Market practices vary, but FWPs are less likely to be delivered to investors with the base prospectus and prospectus supplement attached. Of course, before the adoption of Securities Offering Reform, and the popularization of electronic delivery of prospectuses and other offering documents, PPSs were delivered to investors in paper form with copies of the base prospectus and prospectus supplement attached.

Why Would an Issuer Decide to Use a PPS or an FWP?

Ineligible Issuers. For starters, some structured note issuers cannot use an FWP in place of a PPS. For example, “ineligible issuers” and their distributors may not use FWPs for their offerings, except for the limited purpose of providing preliminary terms of a security.[4] Accordingly, a significant number of structured note issuers, which previously used FWPs for their red herrings, have changed their approach to use PPSs, when they became “ineligible issuers.”

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[1] We discuss the impact of Securities Offering Reform on the structured products market in more detail in our article available here.

[2] A PPS is subject to the detailed disclosure requirements of Regulation S-K, while an FWP may follow a different form. However, because a [red herring] will ultimately be superseded by a final pricing supplement, which is also subject to Regulation S-K disclosure requirements, the form and content of an FWP used as a red herring will largely resemble that of a PPS.

[3] We would mention that our clients advise us that these toll-free numbers are rarely used by investors as a means to obtain a prospectus. You may also find these toll-free numbers in a PPS, even if not required; that is done (a) to help investors and (b) for consistency.

[4] See Rule 164(e). An ineligible issuer may use a “preliminary term sheet” as an FWP, but not much more than that.

Liability Considerations. In terms of liability considerations, an FWP that contains material misstatements or omissions should be viewed in a similar manner as a PPS (or final pricing supplement). If there are misstatements in an FWP, these would trigger liability under Section 12 of the Securities Act in a manner comparable to that for a PPS.

Flexibility. Because a PPS is subject to Regulation S-K, a variety of detailed form and content requirements apply, some of which are "non-negotiable." If a product manufacturer wishes to use a different format to market a red herring, for example, by using a cover page that does not conform to the specific requirements of Regulation S-K, then an FWP may be a more suitable approach.

Disclosure Philosophy. Which is better? A short document, which might be more inviting for an investor to read? Or a longer document, which the reader might immediately discard? On the one hand, many market participants believe that an FWP that links to the longer base documents can include sufficient disclosure for most or all retail investors. On the other hand, other market participants believe that placing the full PPS in front of the reader helps to remove any concerns about the adequacy of the disclosure package. Accordingly, practice varies.

PRIIPs Implementation Date Fast Approaching

As mentioned in our Volume 8, Issue 7[5] publication of *Structured Thoughts*, the EU Packaged Retail Products and Insurance-Based Products Regulation (the "PRIIPs Regulation") will become effective on 1 January 2018.

Requirement for Preparation of a KID

From the start of 2018, any product within the scope of the PRIIPs Regulation can only be sold to an EU retail investor (including a retail client under MiFID II) if a Key Information Document ("KID") is provided in advance to such investor. The KID is intended to be a short-form pre-contractual disclosure document and must not exceed three pages of standard-sized text. The PRIIPs Regulation, together with the Regulatory Technical Standards ("RTSs") set out detailed and prescriptive criteria for the information to be included in the KID.

Scope of the PRIIPs Regulation

For non-insurance products to come within the scope of the PRIIPs Regulation, the amount repayable to investors has to be subject to "fluctuations because of exposure to reference values to the performance of one or more assets which are not directly purchased by the investor." It will not therefore apply to "vanilla" fixed, or floating, rate notes. However, many or most structured products are likely to come within the scope of the PRIIPs Regulation, and any issuer of a product that embeds a derivative or makes any payment of principal, interest or other amount by reference to the value of any asset or index should consider carefully whether the PRIIPs Regulation will be relevant.

Although the territorial scope of the PRIIPs Regulation is not clear on its face, the EU Commission has published guidelines that state that a KID will need to be provided where an in-scope product is made available to EU retail investors (whether or not the product manufacturer or distributor is based outside the EU). However, no KID needs to be provided to any investors located outside the EU, even where the issuer or distributor is within the EU.

Points for Issuers and Manufacturers to Consider

It is important for any issuer/manufacturer of a product that comes within the definition of a PRIIP that may find its way to EU retail investors to either ensure that it is able to comply with the obligation to prepare a KID for such product or to take steps to ensure that it cannot be sold or transferred to EU retail investors. Two key issues here for product manufacturers to bear in mind are:

- Where a PRIIP is to be made available to an EU retail investor, the obligation to prepare the KID is on the product manufacturer (even if based outside the EU). The obligation to deliver the PRIIP to the investor lies with the person advising on or selling the PRIIP to the retail investor. Therefore, although a distributor should not be selling a PRIIP to an EU retail investor unless it knows that the manufacturer has prepared or is preparing a KID, manufacturers should ensure that their distributors are fully aware as to whether the product can be made available to EU retail investors, and that relevant contractual selling restrictions and offering legends reflect this position.

[5] Volume 8, Issue 7 may be accessed here.

- The PRIIPs Regulation applies to sales in the secondary as well as the primary markets and the obligation to produce the KID is still the product manufacturer's in respect of secondary sales. It is therefore important that the whole chain of distributors, be bound by relevant selling restrictions. It is also advisable, where a product is not intended to be sold to EU retail investors, to ensure there is a prominent legend to this effect on the relevant offering documents.

Market Standard Legends and Selling Restrictions

The International Capital Markets Association ("ICMA") has been working with the industry to develop forms of PRIIPs legends and selling restrictions. It has developed language for two options: first, where there is to be a blanket prohibition on sales to EU retail investors (in this case, there is alternative language for standalone issues and for programs where no issuance can be sold to a retail investor); and second, a form of legend/restriction for program issuances that can be switched on or off, depending on whether the particular issuance is to be made available to retail investors.

It they have not already done so, we would recommend that all issuers and manufacturers of packaged or structured products that could be sold into the EU in either the primary or secondary markets consider whether such legends and selling restrictions should be incorporated into their products, and review their contractual arrangements with their chain of distributors.

Benchmark Regulation: Latest on Grandfathering

The vast majority of the provisions under the EU Benchmarks Regulation (the "BMR") come into effect on 1 January 2018. The BMR establishes a new regime for the authorisation and supervision of administrators of financial benchmarks that are used in the EU. Benchmark administrators will be required to comply with a number of obligations, including governance, oversight and control requirements, as well as requirements relating to benchmark methodology. Benchmark administrators located outside the EU will also be subject to the BMR if a benchmark they administer is used within the EU.

Application and Impact of the BMR

The BMR will apply to a wide range of financial instruments where any amount payable thereunder is determined by reference to an index or other figure that is published or made available to the public, and that is regularly determined by reference to a formula or other method of calculation and on the basis of the value of one or more underlying assets or prices, including actual or estimated interest rates.

The BMR is likely to have a particular impact on structured products offerings within the EU as many of these are likely to come within the definition of "financial instrument" and incorporate a benchmark within the scope of the BMR. There are, however, significant transitional provisions that will enable many existing benchmark administrators to continue to provide benchmarks in the EU until 1 January 2020, even without authorisation or registration under the BMR.

EU Benchmark Administrators and Transitional Relief

For benchmark administrators located in the EU, the BMR provides that any index provider that was providing a benchmark in the EU on 30 June 2016 (the date the BMR came into force) must apply for authorisation or registration under the BMR by 1 January 2020. In Technical Advice and in a Q&A document, the European Securities and Markets Authority ("ESMA") has confirmed that EU-based administrators that were providing benchmarks in the EU as of 30 June 2016 may continue to provide benchmarks in the EU (including new benchmarks developed after January 2018) up until 1 January 2020 unless and until the authorisation or registration of the benchmark administrator under the BMR is refused. However, in relation to EU benchmark administrators that only commenced providing a benchmark in the EU after 30 June 2016, ESMA construes the transitional provisions as meaning that in relation to benchmarks that such administrator started providing between 1 July 2016 and 31 December 2017, it can continue to provide such benchmarks up until 1 January 2020 unless and until the authorisation or registration of such administrator is refused. However, any such administrator cannot provide any benchmark created on or after 1 January 2018 in the EU unless it obtains authorisation or registration under the BMR.

Non-EU Benchmark Administrators and Transitional Relief

Different provisions apply in respect of non-EU administrators. There are three routes by which such administrators can have their benchmarks used in the EU: (i) the non-EU administrator is located and subject to supervision in a jurisdiction that the EU Commission has determined has equivalent regulation to the BMR (no such determination has yet been made in respect of any jurisdiction), (ii) the non-EU administrator is recognised by its EU member state of reference (to be determined by specified criteria) as complying with the majority of the provisions of the BMR or (iii) one or more benchmarks administered by such non-EU administrator are endorsed by an EU-supervised entity which has a clear and well-defined role within the control or accountability framework of the non-EU administrator and is able to monitor the provision of the relevant benchmark.

Transitional provisions under the BMR state that any benchmark provided by a non-EU administrator can still be used in the EU after 1 January 2018 if such benchmark is already used in the EU as a reference for financial instruments. ESMA had originally taken the view in Technical Advice that for this purpose, the reference to benchmarks “already used” should be interpreted as meaning a benchmark in use in the EU as of 1 January 2018, meaning that non-EU administrators would not be able to rely on the transitional relief for benchmarks used in the EU for the first time after 1 January 2018. This caused concern among many non-EU administrators as EU competent authorities cannot make a formal recognition determination until after 1 January 2018 (although some, including the UK FCA, have been allowing applications to be submitted in advance).

ESMA then published a revised Q&A document on 8 November 2017 which changed its position. ESMA now states that for the purpose of the transitional provisions relating to non-EEA benchmarks, the term “already used” should instead be interpreted as meaning where the benchmark is already used in the EU on or before 1 January 2020. This revised interpretation therefore allows any non-EU administrators to continue to administer both existing and new benchmarks in the EU up until 1 January 2020. The revised ESMA guidance is considered surprising by many market participants as it puts non-EU administrators in a better position than EU administrators who were not providing an index in the EU as of 30 June 2016. The Q&A is, however, intended to operate as “level 3” guidance under the BMR and market participants should therefore be able to rely on ESMA’s revised guidance.

Although this gives immediate relief to non-EU benchmark administrators in respect of both existing and new benchmarks to be used in financial instruments, we would recommend that such administrators start giving consideration to whether an application for recognition or endorsement of relevant benchmark(s) should be made. It should be noted that (in contrast to the position for EU administrators) even if such an application is not successful, the benchmark can still benefit from the transitional provisions up until 1 January 2020.

Financial Conduct Authority Releases Data Relating to Complaints about Financial Products

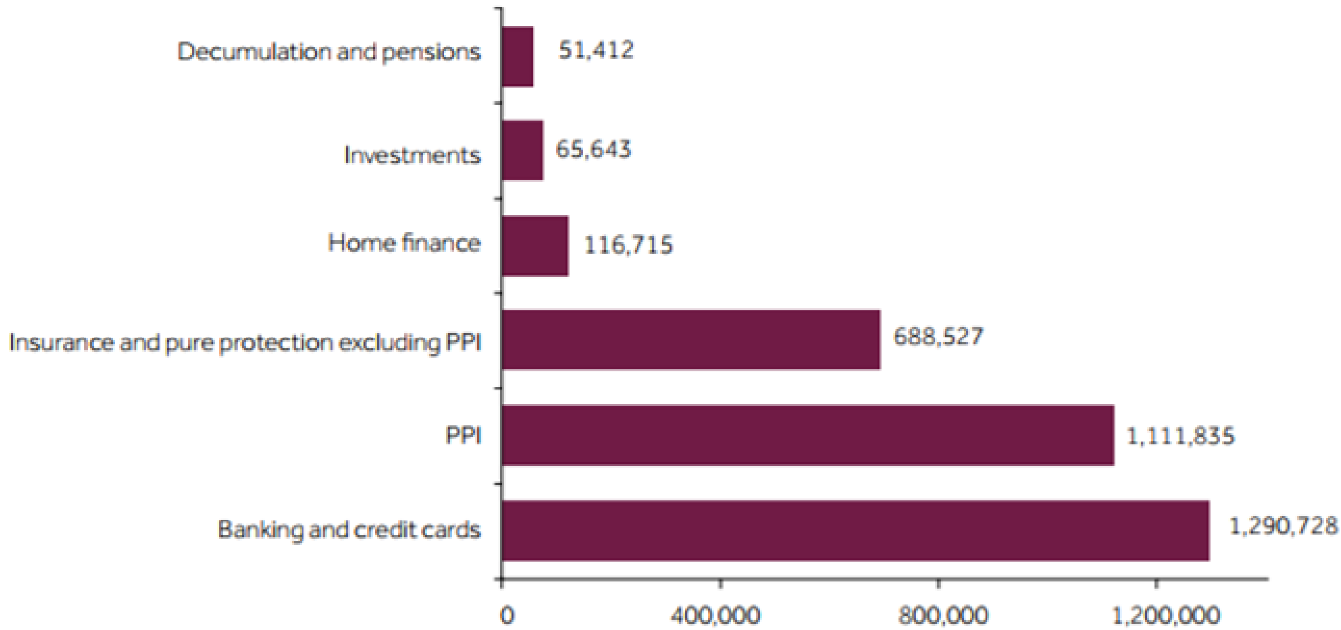
In October 2017, the UK Financial Conduct Authority (“FCA”) released its *Complaints Data Analysis* relating to the first half of 2017.[6] The data showed that in total, 3.32 million complaints were received by firms during this period, an increase of 280,000 complaints compared with the second half of 2016. The total amount of redress paid to consumers as a result of the complaints was £1.99 billion, an increase of £90 million from £1.90 billion in the second half of 2016.

The report analysed the complaints based on a variety of metrics, including complaints by product groups, as shown in the table on page 6 of this newsletter.

Within the “Investments” product category, complaints relating to structured products constitute about 2% of the total complaints for this product category, representing 1,355 complaints out of a total of 65,643 complaints. When contrasted with “Endowments” and “Individual Savings Account (where investment held)” products with each receiving 24% of the total number of complaints in the “Investment” product group, the complaints received for structured products is comparatively lower.
This may be due in part to the relative sophistication of the investors who typically invest in structured products in

[6] The report may be found here.

the United Kingdom. It is also interesting to note that within the “Investment” product group, only 49% of the total complaints were upheld by the firm receiving the complaint; however, among these closed complaints, 93% were resolved within eight weeks (with 3% closing within three days).



(Source: Complaints Data Analysis: 2017 H1, Financial Conduct Authority October 2017)

Notice Extends Phase-In of Section 871(m) Regulations

On August 4, 2017, the Internal Revenue Service released Notice 2017-42 (the “Notice”),[7] which further extends the phase-in of regulations under Section 871(m) of the Internal Revenue Code (the “Regulations”). Section 871(m) is the U.S. federal tax 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.[8]

The Notice extends the effective dates found in certain provisions of:

- IRS Notice 2016-76;
- amendments to the Regulations under Notice 2016-76; and
- the final Qualified Intermediary Agreement.

The extensions are as follows:

[7] The Notice is available here.

[8] For a more detailed discussion of the development of the Regulations, see the following firm publications: our Client Alert on the 2015 final regulations, available here; our Client Alert on Notice 2016-76, available here; a discussion of Rev. Proc. 2017-15 containing the final QI Agreement in Vol. 9 Issue 4 of our *Tax Talk* newsletter, available here; and a discussion of the 2017 amendments to the Regulations in Vol. 10 Issue 1 of our *Tax Talk* newsletter, available here.

- ***Phased-in Application for Delta-One and Non-Delta-One Transactions.*** The Notice provides an extension to the phased-in application of the Regulations to potential Section 871(m) transactions[9] that do not have a delta of one (as determined under the Regulations). Now, the Regulations will not generally apply to non-delta-one transactions entered into before January 1, 2019. The Regulations will continue to apply to any potential Section 871(m) transaction that has a delta of one entered into on or after January 1, 2017, including combined transactions; however, the Notice states that now both 2017 and 2018 will be phase-in years[10] for these transactions.
- ***Phase-in Year for Qualified Derivatives Dealers.*** The Notice extends three portions of the QDD rules.
  - First, previous guidance provided that a QDD will not be subject to tax on dividends and dividend equivalents received in the QDD's equity derivatives dealer capacity until January 1, 2018, which the Notice extends to January 1, 2019.
  - Second, previous guidance provided that a QDD will be required to compute its Section 871(m) tax liability using a "net delta" approach beginning in 2018; the Notice extends this effective date for the net delta approach to begin in 2019.
  - Finally, the final QI Agreement provides that a QDD must perform certain periodic reviews with respect to its QDD activities, but only beginning on January 1, 2018. The Notice extends this date to January 1, 2019.
- ***Simplified Standard for Determining Whether Transactions Are Combined Transactions***. Notice 2016-76 and the subsequent final regulations provide for a simplified standard for withholding agents to apply when two or more transactions should be combined in order to determine whether the transactions are subject to Section 871(m); however, the simplified method only applied for transactions entered into in 2017.[11] The Notice extends the period during which this simplified standard applies to 2018.

Looking Ahead

On February 24, 2017, President Trump issued Executive Order 13777, which directed U.S. agencies to reduce the regulatory burdens created by these agencies. The Notice states that, under this executive order, the Treasury Department and IRS will continue to evaluate the Regulations and consider possible agency actions that may reduce unnecessary burdens imposed by the Regulations. On October 2, 2017, the U.S. Department of the Treasury delivered a report to President Trump that proposes substantial revisions to eight sets of U.S. federal income tax regulations. While the Section 871(m) regulations were not one of the eight, the report states that the Treasury is considering possible reforms to the Regulations.[12] Additionally, on October 26, 2017, the IRS published corrections to the Regulations; these corrections were generally non-substantive in nature.[13] Finally, Dana Trier, Department of Treasury deputy assistant secretary for tax policy, suggested at a District of Columbia Bar Taxation Community luncheon that Section 871(m) could potentially be limited to delta-one transactions only.[14]

The Notice states that taxpayers are permitted to rely on it until the Regulations and the final QI Agreement are amended to reflect the extensions provided for in the Notice.

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[9] *See* section 1.871-15(a)(12). A "Section 871(m) transaction" is any securities-lending or sale-repurchase transaction, specified NPC, or specified ELI. A "potential Section 871(m) transaction" is any securities lending or sale repurchase transaction, NPC, or ELI that references one or more underlying securities.

[10] Under the Regulations, when enforcing the Section 871(m) regulations for the applicable phase-in years, the IRS will afford relief to taxpayers or withholding agents who have made a good faith effort to comply with the regulations. Relevant considerations for the determination of good faith include whether a withholding agent made a good faith effort to: (i) build or update its documentation and withholding systems to comply with the Section 871(m) regulations, (ii) determine whether transactions are combined, (iii) report information required under the Section 871(m) regulations, and (iv) implement the substantial equivalence test.

[11] Under the Regulations, in 2017 a short party may presume that transactions are not entered into in connection with each other if either (i) the long party holds the transaction in separate accounts and the short party does not have actual knowledge that the accounts were created separately to avoid Section 871(m), or (ii) the transactions were entered into two or more business days apart. Notice 2016-76 and the Regulations provided that, for 2017, a broker may presume that transactions should not be combined for Section 871(m) purposes unless they are over-the-counter transactions that are priced, marketed, or sold in connection with each other.

[12] For a more detailed analysis of this report, please see our Client Alert, available here.

[13] A copy of the published corrections is available online and may be accessed here.

[14] *See* Stephanie Cumings, "Treasury Reconsidering Dividend Equivalent Rules," 2017 TNT 211-3 (November 2, 2017).

EU Regulatory Agenda: What to Expect in 2018

From a regulatory viewpoint, 2017 was mostly a year for implementing laws and regulations that had already been agreed in principle. There were no more Brexit bombshells, although there was still one politically controversial move from the European Commission, in the shape of a proposal for the enhanced supervision of clearing counterparties, which included the ability to require certain clearing counterparties to relocate to the EU. Below, we look back at some of the recent regulatory developments that will affect the European structured products market into 2018 and beyond.

Brexit: On 29 March 2017, the UK government formally notified the European Council of the UK's intention to withdraw from the EU. The effect of Article 50 of the Treaty on the European Union is that the UK now has until 29 March 2019 to negotiate and agree the terms of the UK exit.

There is still considerable uncertainty as to what the nature of the UK's relationship with the EU will be, following its exit. At the time of writing, the EU's Brexit negotiating team has indicated that discussions can now begin to take place on the post-Brexit relationship, as a result of it concluding that sufficient progress has been achieved on certain points (including the post-Brexit status of non-UK citizens resident in the UK, the amounts that the UK should pay to the EU in respect of EU budgetary funding that has already been committed to, and the nature of the post-Brexit border between Northern Ireland and the Republic of Ireland). The UK government has indicated that it is working to complete a final deal on the UK's future relationship with the EU by October 2018. It has also said that it wants to reach an outline agreement with the European Union, by the end of March 2018, on the transitional arrangements that will apply temporarily after it leaves the EU on 29 March 2017 (assuming no extension is agreed by the other EU member states to the March 2019 date). It is not yet clear what the desired length of such a transitional period would be, or what the UK's obligations and rights would be during such a period.

It still remains likely that UK financial services firms will no longer be able to take advantage of the MiFID "passport" post-Brexit, in which case separate authorisation may be necessary for UK firms carrying out financial activities in the EU, unless they are able to rely on "equivalence" provisions in MiFID II and other EU legislation.[15]

The UK still remains, for now, a member of the EU, and existing EU-derived laws and regulations continue to apply to the UK.

While the negotiations continue, there still remains considerable uncertainty on various matters, such as:

- the terms of the relationship between the UK and the EU after 29 March 2019, including whether or not the UK will remain part of the single market, and if so whether that would be purely during the period of any agreed transitional period; and
- the extent to which, in a transition period, there would be any difference in the rights and obligations of the UK as they currently stand.

PRIIPs: As discussed in "PRIIPs Implementation Date Fast Approaching" above, the PRIIPs regulation will now become applicable on 1 January 2018. The range of products that are within the scope of the PRIIPs regulation is very broad and the vast majority of structured products will be captured. This regulation will require that whenever a product within the scope of the PRIIPs regulation is offered to an EU retail investor, an additional short form disclosure document, called a KID, must be provided to that investor before they make their investment decision. The obligation to provide the KID falls on the product manufacturer, even if they are located outside the EU, whereas the obligation to provide the KID to the retail investor rests with the person who is selling or advising on the product to the investor.

If sales to EU retail investors are not envisaged by the product manufacturer, then there are various steps that it may be prudent for the manufacturer to take, in order to guard against the product inadvertently ending up in the hands of EU retail investors, including adopting selling restrictions, legends and other contractual provisions.

Benchmark Regulation: As discussed earlier in "Benchmark Regulation: Latest on Grandfathering", the vast majority of the provisions of the EU Benchmarks regulation will become applicable on 1 January 2018 and will regulate the

[15] "MiFID" and "MiFID II" refer to the recasting of the Markets in Financial Instruments Directive that will apply from January 2018. See below for a summary of relevant MiFID II developments.

authorisation and supervision of administrators of "benchmarks" (as defined in the Benchmark Regulation) used by EU regulated entities. Where the administrator of a benchmark is located in the EU, it will need to be duly authorised and registered. Where it is located outside the EU, it will have to be either from a jurisdiction which is considered equivalent for the purpose of the Benchmark Regulation (no jurisdictions have yet been declared equivalent) or the administrator must be recognised by its EU member state of reference or its benchmarks must be endorsed by an EU-supervised entity.

Non-EU benchmark administrators will need to start giving consideration to whether an application for recognition or endorsement of their relevant benchmarks should be made, although the transitional provisions of the Benchmark Regulation, and the interpretation of those provisions by ESMA, will provide a reasonable time period within which to formulate and enact their EU strategies.

EMIR: The European Market Infrastructure Regulation ("EMIR"), which regulates derivatives in the EU, has been in force since 2012. In the years since then, much of the relevant subsequent rule-making required under EMIR has been introduced by technical standards, through delegated legislation.

In particular, in relation to mandatory central clearing for derivatives entered into by financial counterparties and certain significant non-financial counterparties ("NFC+s"), as we reported in our special issue of Structured Thoughts dated 27 December 2016[16], counterparties were categorised as Category 1, Category 2 or Category 3 counterparties, with the effective date for mandatory clearing being staged depending on the category of counterparty. Category 3 counterparties (financial counterparties or alternative investment funds, who are not clearing members of an EU authorised central clearing counterparty, and whose outstanding trades have a gross notional amount of EUR 8 billion or less) were to become subject to the clearing obligation from 21 June 2017 (for OTC interest rate derivatives denominated in EUR, GBP, JPY and USD), and 9 February 2018 for OTC index credit default swaps and OTC interest rate derivatives denominated in NOK, PLN and SEK. On 16 March 2017, the European Commission adopted a delegated regulation which extended the phase-in period for such Category 3 counterparties; the new effective date for the clearing obligation for Category 3 counterparties will now be 21 June 2019, in respect of all the above types of OTC derivatives.

In relation to the required exchange of margin for non-cleared derivatives, the largest counterparties have already had to exchange initial margin for several months now under the relevant EMIR regulatory technical standards ("Risk Mitigation RTS"). Between now and September 2020, all counterparties trading derivatives with an aggregate notional amount in excess of EUR 8 billion will be subject to these requirements, unless another exemption applies. In addition, broadly speaking, the variation margin requirements began to apply to most counterparties from 1 March 2017. However, regulators recognised that many counterparties were not in a position to meet the new variation margin requirements from that date and the FCA, among others, made a statement that they would take a proportionate, risk-based approach to supervision and enforcement and would use judgement as to the adequacy of progress made. The FCA hinted at a policy of forbearance so long as an in-scope firm was able to demonstrate it had made best efforts to achieve full compliance, and to have detailed and realistic plans in place to achieve compliance in as short a time as practicable.

The Risk Mitigation RTS provide detailed rules for the exchange of margin and they currently exempt physically-settled foreign exchange forwards, foreign exchange swaps and currency swaps from the requirement to post initial margin. However, unlike the rules in other jurisdictions, such as Title VII of the Dodd Frank Act in the U.S., the Risk Mitigation RTS did not contain any exemptions for physically-settled foreign exchange forwards from the requirements to exchange variation margin.

On 16 November 2017, the Council of the EU published its second Presidency Compromise Proposal on the proposed regulation to amend EMIR (see below for further discussion), and this proposal stressed the need for international regulatory convergence in relation to the margin treatment of physically-settled foreign exchange forwards, stating "in view of their specific risk profile, it is appropriate to restrict the mandatory exchange of variation margins on physically-settled FX forwards to transactions between the most systemic counterparties."

On 18 December 2017, the Joint Committee of the three European Supervisory Authorities published draft regulatory technical standards to amend the existing Risk Mitigation RTS in relation to physically-settled FX forwards. According to these draft standards, if either counterparty to the FX forward is an entity who is neither (a) an EU credit institution or EU MiFID investment firm (each, an "institution"), nor (b) a non-EU entity that would be an institution if it were established in the EU, then no variation margin will need to be exchanged.

[16] *See* our special issue of *Structured Thoughts*, available here.

The new standards will only become effective the day after they are published in the Official Journal. As a result, the above changes are unlikely to be effective by 3 January 2018 (the date on which the variation margin requirements for physically-settled FX forwards are scheduled to come into force).

Consequently, the ESAs have stated that, for institution-to-non-institution transactions, competent authorities should apply the EU framework in a risk-based and proportionate manner until the amended RTS enter into force. In practice, this is expected to mean that competent authorities will not seek to enforce variation margin arrangements for trades that will not require variation margin when the amended RTS eventually become effective.

In relation to the review of EMIR, on 4 May 2017, the European Commission published a legislative proposal for a regulation to amend EMIR, as we wrote in our earlier client alert[17]. In that client alert, we highlighted various concerns with the European Commission's legislative proposals, including the change to the classification of some counterparties, such as securitisation special purpose entities and the range of alternative investment funds that would fall within the definition of "financial counterparty". The latest Council of the EU compromise proposal does not classify SSPEs as financial counterparties and also restricts the range of AIFs that would constitute financial counterparties to those that are established in the EU or whose manager is authorised or registered under the EU's AIFM Directive. If this compromise proposal is ultimately agreed, it will mean that SSPEs and a large proportion of alternative investment funds will (as is currently the case) not be subject to EMIR's clearing and margin provisions, unless they constitute NFC+ entities.

Agreement on the terms of the EMIR II Regulation is expected during the course of 2018.

MiFID II: The MiFID II legislative package, consisting of the recast Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation ("MiFIR") is required to have been implemented into the national laws of the EU member states by 3 January 2018.

This package includes the new product governance rules that must be observed by MiFID firms that act as either manufacturer or distributor (or both) of financial instruments. These rules revolve principally around the concepts of product manufacturers:

- undertaking a product approval process for each product before it is marketed or distributed;
- identifying the target market for each product and ensuring that the product is designed to meet the needs of such target market;
- ensuring the distribution strategy is consistent with the identified target market; and
- taking reasonable steps to ensure the product is distributed to the target market.

These are all familiar concepts for UK-based manufacturers of structured products, since they are derived from the FCA's 2012 guidelines for structured products manufacturers, but they represent a major set of new obligations for non-UK firms and firms not involved in structured products. These product governance rules will apply in addition to the existing MiFID point-of-sale obligations to determine suitability or appropriateness of a product or service for a particular client. Where a MiFID firm acts as a distributor of a product manufactured by a non-EU firm, it will still have product governance obligations as a distributor (including performing its own target market assessment and identifying its own distribution strategy) and will need to reach agreement with the non-EU manufacturer to provide it with the information it needs to comply with its obligations.

New, more restrictive, rules will apply from 3 January 2018, concerning acceptance by MiFID firms of fees or commissions or non-monetary benefits from third parties. Fees for investment research will need to be unbundled from dealing commission and other execution fees and paid for either by the firm out of its own resources, or from a research payment account, funded by a specific research charge to the client.

The "execution-only" exemption from performing the appropriateness test will be narrowed as from 3 January 2018 and will not be available for bonds or other securitised debt that incorporate a structure which makes it difficult for the client to understand the risks involved, nor will it be available for structured deposits incorporating a structure which makes it difficult for the client to understand the risks involved or the costs of exiting the product before the end of its term.

MiFID II also introduces a new type of market, an organised trading facility ("OTF"), and extends the pre- and post-trading transparency requirements to bonds, structured finance instruments and derivatives traded on OTFs, as well as on

[17] *See* "Proposed EMIR II – Key Points for Derivatives Markets Participants," available here.

regulated markets ("RMs") and multilateral trading facilities ("MTFs"). Waivers from these requirements may still be granted by competent authorities, but on narrower grounds than have been available to date.

MiFID II also finally introduces the requirement for centrally-cleared derivatives, that are determined to be subject to a trading obligation by ESMA, to be traded only on an RM, MTF or OTF, or on a third country venue meeting certain equivalence requirements. On 5 December 2017, the European Commission adopted a decision to determine that U.S. laws and supervisory frameworks for designated contract markets and swap execution facilities are equivalent to the provisions of MiFIR for trading venues.

Also of note is that the advent of MiFID II will trigger the effectiveness of the provisions of the Market Abuse Regulation, which extend the scope of financial instruments covered by MAR to include those traded on an OTF, as well as on a RM or MTF.

Prospectus Regulation (PD3): The EU's new Prospectus Regulation entered into force in July 2017 and the vast majority of its provisions will take effect from 21 July 2019. Work is now under way preparing the detailed implementing legislation, hopefully to be finalised in good time for market participants to prepare for the new rules.

In terms of exemptions from the requirement to prepare a prospectus, the Regulation will not apply at all to an offer of securities to the public with a total consideration of less than EUR1 million over a 12-month period. Such figure may be increased, up to a maximum of EUR8 million, by each member state. Notably, the "wholesale denomination" exemption for public offers of securities with a minimum denomination of EUR100,000 has been retained.

For such high-denomination securities that are admitted to trading on a regulated market, and for other non-equity securities that are to be traded only on markets (or segments thereof) to which only qualified investors have access, lighter (proportionate) disclosure requirements are envisaged, and will be contained in the implementing legislation now being prepared.

For such securities, no prospectus summary will be required under the new regime. In the case of prospectuses for other securities, the prospectus summary must be no longer than seven pages of A4-sized paper, must be presented and laid out in a way that is easy to read, with characters of readable size and written in a style and language that facilitates the understanding of the information. It may contain no more than the 15 most significant risk factors specific to the issuer.

A summary will no longer be required in the base prospectus itself, but the final terms for each issuance of securities must include, as an annex to the final terms, a summary of that issuance.

Risk factors will be required to be presented in a limited number of categories, depending on their nature, and must be ranked by materiality, based on both the probability of their occurrence and the expected negative impact if the relevant risk occurs.

A new Universal Registration Document regime will be brought in by the new Regulation, similar to the U.S. shelf registration system. Issuers with a URD will benefit from a faster approval process and after having had a URD approved by the relevant competent authority for two consecutive years will be allowed to file further URDs without prior approval, although they will still be subject to review by the authority.

The relevant EU competent authority may permit a non-EU issuer to draw up the required prospectus under the rules of its home jurisdiction, provided that those rules are determined to be equivalent to the Regulation and cooperation arrangements are in place between the relevant authorities in its home jurisdiction and the relevant EU competent authority.

U.S. Regulatory Agenda: What to Expect in 2018

Each year for the last several years, we have shared with our readers our list of anticipated areas of regulatory focus for the coming year. Although we are one year into the Trump administration, making predictions about the future course of legislative and regulatory developments has not gotten any easier. We have omitted any discussion of issues that may arise as a result of tax law changes. Below, we highlight a number of the key matters affecting the U.S. market that we will be following closely:

Department of Labor's fiduciary rule: The Department of Labor's ("DOL") fiduciary rule has been highly controversial and has been challenged in court as well as through proposed legislation that would have rescinded the rule. In February 2017, President Trump directed the DOL to re-evaluate the fiduciary rule and its consequences. Only a portion of the DOL fiduciary rule as adopted in 2016 went into effect in June 2017, the initial applicability date. The remaining provisions were scheduled to become applicable in January 2018. However, recently, the DOL deferred the applicability date until July 1, 2019, in order to afford the DOL additional time to consider the issues that were identified in President Trump's directive. The delay also gives the DOL more time to coordinate with the SEC. The U.S. structured products industry will be significantly affected by these developments, including the types of products that are sold, what types of investors they are sold to, and the nature of the distribution arrangements and compensation.

SEC rulemaking on a heightened standard for broker-dealers: The SEC, led by Chair Jay Clayton, has shown interest in addressing a heightened standard for broker-dealers, which may be more akin to a "best interest" standard. Recently, the SEC requested public comment on questions relating to a uniform fiduciary standard for broker-dealers and investment advisers. The request for comments referenced the possibility of a disclosure-based approach to conflicts of interest, rather than focusing solely on a fiduciary standard such as that applicable to advisers. Any SEC standard will relate to retail investors generally and will not be limited to retirement accounts. It is reasonable to anticipate that in 2018, the SEC will propose for comment a heightened standard of care for broker-dealers.

FINRA rule on seniors: New FINRA Rule 2165 relating to the financial exploitation of seniors, and the accompanying amendments to FINRA Rule 4512, becomes effective on February 5, 2018. As we have discussed in our prior publications[18], Rule 2165 allows broker-dealers to place a temporary hold on the disbursement of funds and securities from the accounts of seniors where there is a reasonable belief that financial exploitation is occurring.

Continued focus on seniors and other at risk investors: There are several legislative initiatives, including the Senior Safe Act, that have garnered bipartisan approval and that are intended to protect senior investors and other "at risk" investors from financial exploitation. In addition, state securities regulators remain focused, as does FINRA, on enforcement activities that target exploitation of seniors and at risk investors, including as a result of misselling, churning, reverse churning, and excessive fees.

FINRA fixed income mark-up rules: The amendments to FINRA Rule 2232 that will require broker-dealers to disclose additional transaction-related information, including mark-ups, for fixed income transactions entered into with retail customers on a principal basis become effective on May 14, 2018.

Amendments to other FINRA rules: In prior issues of this newsletter, we commented on FINRA's proposed amendments to FINRA Rule 5110, or the Corporate Financing Rule, which affects most financing transactions, as well as FINRA's request for comment regarding possible amendments to other FINRA rules that affect capital formation. We expect that the amendments to FINRA Rule 5110 will move forward early in 2018. FINRA has also announced its intention to amend its suitability rules to address concerns as to "churning."

FINRA 360 initiative and retrospective review of rules: Since announcing its FINRA 360 initiative, FINRA has undertaken a number of measures intended to provide greater transparency for broker-dealer member firms. Also, FINRA has announced a retrospective review of various of its rules. We expect that the 360 initiative will continue to provide useful information for member firms regarding FINRA's priorities, FINRA's exam findings, and other important matters.

FINRA guidance on social media: Although FINRA provided additional social media-related guidance earlier in the year, we expect that social media usage will continue to be an area of focus for FINRA, and additional guidance in the area may be needed. This guidance may be of increasing relevance to the structured products industry, as marketers use new media to communicate information about different product offerings.

FINRA examinations and enforcement: FINRA's recently issued report on examination findings highlights principal areas of interest. It is clear that FINRA will continue to remain focused on product suitability, misselling of complex products, fee disclosures, and similar issues.

FINRA's cross-selling sweep and conflicts of interest: In October 2016, FINRA announced a cross-selling sweep in which it requested information regarding the extent to which member firms were promoting bank products of affiliated or parent companies or other services offered by affiliates (such as securities-based lending arrangements) to retail broker-

[18] *See* our BD/IA Regulator post "SEC Approves FINRA's Rules to Protect Seniors from Financial Exploitation" available here.

dealer accounts. We anticipate that both FINRA and the SEC will remain focused on broker-dealer conflicts of interest, incentives to recommend particular products (including proprietary products and structured products), and related matters.

SEC enforcement focus: As we have noted in prior issues of this newsletter, SEC Chair Clayton has made it clear that the SEC will focus on protecting retail investors. To that end, a Retail Strategy Task Force has been created within the Division of Enforcement that will seek to identify incidents of misconduct that target retail investors, including through the use of advanced data analytics. Recently, the SEC announced the appointment of a new chief of the Division's Complex Financial Instruments Unit. This unit will focus on misconduct related to complex financial products.

SEC rulemaking: Quite a number of the rulemaking initiatives that we have been following have been relegated to the "long-term actions" category in the SEC's most recently released regulatory agenda. For example, for some time now, we have been monitoring rulemaking mandated by the Dodd-Frank Act, including changes to various rules under the Securities Exchange Act to replace the use of credit ratings, the incentive-based compensation rules for financial services entities designed to mitigate excessive risk-taking, the conflicts of interest rule required by Section 621 of the Dodd-Frank Act, and various security-based swap rules—all of these have been sidelined for the moment.

Regulatory burden relief: Likely few of the regulatory burden relief measures being considered by the banking agencies or incorporated in proposed legislation will have a significant effect on the bank holding companies that are the principal issuers of structured notes in the U.S. market. Changes to the Volcker Rule, to the extent that these relate to the market-making and underwriting exceptions or clarify the definition of "proprietary trading," may be helpful to structured note issuers and their affiliated broker-dealers.

What's a "structured note"?: In Canada, for purposes of understanding which obligations are "bailed in"; in Europe, for purposes of MREL; and in the United States, for purposes of determining which debt securities are eligible long-term debt meeting the TLAC requirement, there likely will continue to be discussions relating to which types of notes are "structured notes."

Regulation of cryptocurrency: Many market participants have expressed interest in issuing notes that reference cryptocurrency-related indices, the performance of cryptocurrencies, or, more recently, futures contracts. Both the Commodity Futures Trading Commission and the SEC have been keenly focused on cryptocurrency and the regulation of various of the instruments being developed, marketed, and sold, which may, depending on format, be considered "commodities," "securities," or "futures." We anticipate that, given the degree of interest in the area and the pace of change, there are likely to be many developments to watch in 2018.

The year of platforms?: Industry participants seem quite interested in the development of various structured note issuance and pricing platforms. Depending upon the types of functionalities offered by a platform, there are many legal issues to consider for an issuer that chooses to have its structured notes offerings posted on the platform or that chooses to provide pricing. In a future issue of this newsletter, we will review with readers the SEC's views on liability for third-party content, the basics of hyperlinking, and the "envelope" and "cul-de-sac" approaches for websites containing offering-related materials and other non-offering-related content.

Upcoming Events

Fed's TLAC Rule
Monday, January 8, 2018:
PLI Webinar, 1:00 p.m. – 2:00 p.m. EST

In December 2016, the Federal Reserve Board adopted final rules relating to a long-term debt, total loss absorbing capacity (TLAC), and clean holding company requirement. The rules apply to U.S. G-SIBs and for foreign banks that are G-SIBs and subject to an intermediate holding company requirement. Join us for an overview. Topics will include:

- The Fed's final rules;
- Principal differences between the Feds rules and the FSB approach;
- Considerations for foreign banks subject to the rules;

- An assessment of the U.S. internal TLAC requirement compared to the IHC requirement proposed by the European Commission; and
- Effects on other financial products.

Speaker: Oliver Ireland, Partner, Morrison & Foerster LLP

PLI will provide CLE credit.

For more information, or to register, please click here.

Regulatory Burden Relief and Reform & What to Expect
Thursday, January 18, 2018
IFLR Webinar, 12:00 p.m. – 1:30 p.m. EST

There was no shortage of news in 2017 and the year ended as dramatically as it began. In this session, we will provide a focused recap of the most significant developments related to regulatory burden relief in the United States. We also will share our insights and predictions regarding the changes to anticipate and prepare for in 2018 in the following key areas:

- regulatory relief measures taken by or under consideration by the banking agencies;
- legislative regulatory relief measures affecting financial institutions;
- the future of the CFPB and fintech related developments;
- a fiduciary or best interests standard for broker-dealers, the likely next steps to be taken by the SEC and where things stand with the Department of Labor's rule;
- the SEC's rulemaking and enforcement agenda for investment funds and investment advisers;
- SEC rulemaking priorities likely to affect capital formation; and
- legislative proposals relating to the securities laws.

Speakers:

- Jay Baris, Partner, Morrison & Foerster LLP
- Hillel Cohn, Senior Of Counsel, Morrison & Foerster LLP
- Oliver Ireland, Partner, Morrison & Foerster LLP
- Anna Pinedo, Partner, Morrison & Foerster LLP

CLE credit is pending for California and New York.

For more information, or to register, please click here.

***GlobalCapital* has named us Global Law Firm of the Year at its 2017 Global Derivatives Awards for the second year in a row**.

For the third year in a row, *GlobalCapital* named us the Americas Law Firm of the Year at its 2017 Americas Derivatives Awards.

We have again been named Best Law Firm in the Americas by StructuredRetailProducts.com at the 2017 StructuredRetailProducts and Euromoney Americas Wealth Management and Derivatives Conference.

When it comes to advising financial institutions, whether it's bank regulatory advice, debt or equity offerings, derivatives, securitization or structured products, Morrison & Foerster leads the way.

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Join Our *Structured Thoughts* LinkedIn Group

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

To join our LinkedIn group, please click here and request to join, or simply
email Carlos Juarez at cjuarez@mofo.com.

For more updates, follow Thinkingcapmarkets, at our Twitter feed: www.twitter.com/Thinkingcapmkts.

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