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Structured Thoughts

News for the financial services community.

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Structured Notes and Issuer Quiet Periods

Background

Most issuers establish a "quiet period" (also called a "blackout" period) prior to the release of potentially sensitive information and material non-public information, such as quarterly earnings announcements. During this period, they will refrain from offering securities, particularly in registered offerings or to retail investors.

An issuer may impose a blackout period if it is aware of other information that, once announced, may have a significant effect on its stock price or credit spreads. These events could include an acquisition, a disposition, or the entry of an order or judgment by a court or a regulator, etc. During the blackout period, the issuer may be deemed to be in possession of material nonpublic information about the recently completed quarter, for example, that might affect an investor's decision regarding an investment in the issuer's securities.

Usually, the issuer's treasury group (or the group that is responsible for funding), together with counsel supporting that group's functions, determines the terms of its blackout policy, which may also be discussed with and approved by the issuer's board of directors or other senior management. Generally, the treasury group and its counsel are the stakeholders that are most familiar with the issuer's funding plans, and therefore can communicate with all of the relevant business groups about the blackout policy.

Traditional Blackout Periods

In the United States, there is no bright line rule regarding the length of an issuer's blackout period. Some bank and bank holding company issuers adopt a blackout policy that, for example, commences two days before the quarter-end and ends at the commencement of trading on the day following the issuance of the earnings release. Over time, however, many issuers have reviewed their blackout policy and determined that, given the relatively easy access to current information, it

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may be appropriate to end the blackout period immediately following the earnings release. There is some variation in practice in this area.

Refinements to Blackout Periods

Some issuers that frequently access the public markets usually have formulated more detailed blackout policies that distinguish among the types of securities offered.

For example, many issuers will adopt an abbreviated blackout policy in respect of certain structured products, whether in the form of notes, certificates of deposit, or "certificates" and warrants, in which the payout on the instrument depends on the performance of a reference asset. For example, for structured securities, they may impose a blackout that begins two days prior to the date of the earnings release and ends either after earnings are announced, or on the business day following the release.

The risk of offering securities outside of the traditional blackout period is that the issuer may be deemed to be in possession of material nonpublic information about the recently completed quarter that would affect an investor's decision whether to purchase the structured securities. However, many market participants take the view that this risk is mitigated with respect to structured securities because:

- Investors in structured securities will focus principally on the return on the securities, which is linked to an external reference asset. As a result, information about the issuer's business, operations, capital structure and financial condition is not typically as material to an investor in these products as it would be for an investor in other securities of the issuer where the value is driven by the issuer's performance, except to the extent that such information materially increases the likelihood that the issuer would be unable to meet its obligations as they come due. For example, if the issuer had reason to believe that the rating of its debt securities would be reduced due to the information in its upcoming earnings release, that information would likely be more material, since structured securities are priced in part based on the relevant issuer's credit rating. However, if the information in its earnings release is more typical in nature, and consistent with analyst and market expectations, this information is much less likely to have an impact on the value of the issuer's structured securities.
- The risk is further mitigated with respect to structured securities that have shorter maturities. The issuer's ratings usually have less impact on the pricing of shorter term notes.
- Generally, structured securities do not have a large secondary trading market in which their pricing varies to a significant extent based upon news announced by the issuer. Usually, the market for structured securities is largely illiquid, and depends upon the willingness of the issuer's affiliated broker-dealer to make a market in these securities. Accordingly, the issuer's news announcements do not tend to have as great an impact on the prices of structured securities in the secondary market as they do for the issuer's more liquid securities.

Pricing and Settlement

Typically, an issuer also will specify in its blackout policy the issuer's approach to the launching, pricing and closing of an offering of its securities. Some issuers prohibit the pricing and closing of securities during the blackout period, even if the marketing of the securities occurred prior to the commencement of the blackout.

Other issuers adopt more nuanced policies. If the issuer has a bifurcated blackout policy with a shorter period applicable to structured securities, the issuer might consider adopting some guidance or setting parameters as to the steps that occur around the relevant period.

For example, will the issuer permit the marketing of structured securities, provided that the securities price and close after the blackout period? Will the issuer permit securities offerings to straddle the blackout period (i.e., trade date prior to blackout with close after blackout)? Or will that be permitted only with a reconfirmation of trade terms? Will the issuer permit any settlement during the blackout period?

Under U.S. securities laws, the most relevant point in time during the offering is the pricing date, and not the closing date. In connection with its Securities Offering Reform rules, which became effective in December 2005, the SEC set forth its analysis that the critical time for determining the accuracy of a prospectus is the time at which a contract to purchase the securities is formed; that is, the pricing date. After the pricing date, the investor has already made its investment decision, and accordingly, it is not appropriate to base an insider trading claim on information that came to the issuer's

attention after that time. As a result, in the United States, the focus is typically on the information that is available on the date of pricing. Accordingly, some issuers of structured notes into the United States permit structured notes to close (settle) even during the shortened blackout period, because the investors have made their investment decisions prior to that time.

Blackout Period Discretion and Unusual Circumstances

A blackout period should not be immutably set in stone. Even after determining and documenting a blackout policy, the issuer should have the ability to instruct the business units to halt the marketing or issuance of securities at any time as needed. For example, the issuer may identify a concern regarding material non-public information, or it may plan to make a significant news announcement. The issuer and its underwriters will need to exercise caution in implementing a blackout period of this kind - they do not want to signal to the market in this manner that (good or bad) news is about to come forth.

Key Regulators Speak at Washington Structured Products Conference

On November 5, 2015, Structured Products magazine conducted its annual regulatory conference in Washington, D.C. The conference enabled market participants to hear from key regulators in the sector as to a variety of areas of current regulatory focus, and useful reminders of legal requirements and best practices.[1]

Exchange-Traded Products

Michael Coe, Assistant Director of the SEC's Division of Trading and Markets, provided an overview of the SEC's recent inquiry as to exchange-traded products. Our firm discussed the nature of the SEC's inquiries in the June 23, 2015 issue of this publication.[2] Mr. Coe summarized the areas of focus in the SEC's request for comment. He also indicated that the SEC was carefully reviewing the events that occurred in late August 2015, when, among other things, a significant number of ETFs experienced trading prices that differed dramatically from their net asset values. The SEC will utilize the results from this review in order to determine whether any changes in SEC rules, or other actions, are appropriate.

FINRA Advertising

Dave Roscum, Manager of FINRA's Advertising Regulation Department, delivered a presentation relating to FINRA's filing requirements relating to structured products offering documents. These filing requirements have been in effect since early 2013, and have enabled FINRA's advertising department to review and comment on a wide range of market materials used in structured note offerings.

Mr. Roscum observed that, in the view of FINRA, a significant number of filed documents required revisions; however, the number has decreased as compared to prior years. Mr. Roscum reminded the audience that properly prepared marketing materials for structured products:

- should not over-promise the possible returns on an instrument;
- should state that they are not suitable for all investors; and
- should disclose all relevant fees.

Mr. Roscum also reminded market participants that:

- structured CD marketing materials need not be filed under Rule 2210, as they are not "securities"; and
- "generic marketing materials" that do not relate to a specific offering need not be filed.

[1] As is customary for similar public appearances, the regulators reminded audience members that the views expressed reflected those of the individual participants, and not necessarily those of the SEC or FINRA itself, as the case may be.
[2] Please see http://www.mofo.com/~/media/Files/Newsletter/2015/06/150623StructuredThoughts.pdf.

Enforcement Trends

Keith Strycula, head of the Structured Products Association, moderated a panel consisting of Reid Muoio, Deputy Chief of the SEC's Complex Financial Instruments Unit, Mark Fernandez, Senior Regional Counsel of FINRA's Department of Enforcement, and John Brodersen of the SEC's Office of Compliance and Inspections.

The panel discussed how situations come to the attention of the SEC's and FINRA's enforcement division, including as a result of investor complaints, the examination process and in some cases, through so-called "whistle-blowers."

Panelists advised that among the regulatory issues under scrutiny was "switching," where investors were advised to sell a product prior to maturity. In some of these cases, investors were advised to reinvest the proceeds in substantially comparable products, such that the associated fees and commissions of the trades outweighed any benefits to the investors. In contrast, there are likely to be a variety of situations in which a sale prior to maturity, followed by reinvestment in a different structured product, may be a suitable strategy. Mr. Muoio also discussed a variety of aspects of the SEC's recent settlement relating to a proprietary currency trading strategy.[3]

Long-Term Debt, TLAC and Survivor Options

Issuers and distributors of retail fixed and floating rate notes, and simple rate-linked structured notes, were probably pleased about the potential for issuers to include these types of instruments in an issuer's "TLAC."[4] Under the Federal Reserve Board's proposed regulations and definitions, a variety of these instruments are eligible instruments.

However, there are a variety of potential limitations here. For example, under the proposed regulations, these types of instruments could be disqualified by the inclusion of a survivor's option feature.[5]

Proposed Regulation 252.61 contains the definition of "eligible debt security." Clause (5) of the definition would exclude any instrument that can be accelerated based upon any condition other than a failure to pay or a bankruptcy-related event. This would appear to exclude instruments that provide for a survivor's option, which become payable when the beneficial holder passes (or becomes incompetent). In addition, Regulation 252.62, which spells out the long-term debt requirement for G-SIBs, would exclude from the calculation those debt instruments that have a remaining term of less than one year, and would treat an instrument with a conditional right of the investor to request repayment of the debt as if all of the necessary conditions had been satisfied - hence, the deemed remaining term of an instrument with a survivor's option would be reduced to zero - providing no value for purposes of the required long-term debt calculation.

Some survivor options limit the principal amount per year, or in total, that can be exercised. Although these limitations are designed to ensure that most of the principal amount could not become payable under a survivor's option over a short period, provisions of this kind would not appear to help ensure the eligibility of the debt securities for TLAC purposes.

Accordingly, when it comes to retail notes and simple rate-linked notes, G-SIB instruments may become less attractive than similar instruments that are issued by non-G-SIBs, to the extent that G-SIBs are unable to offer a survivor option feature. Accordingly, in connection with these types of offerings, G-SIB issuers may need to offer investors a higher interest rate or other superior terms as compared to G-SIBs. This result seems inconsistent with the regulatory design to ensure that G-SIBs achieve the required levels of long-term debt and to maintain a broad investor base.

[3] We discussed this matter in our October 15, 2015 issue of Structured Thoughts: http://www.mofo.com/~/media/Files/Newsletter/2015/10/151015StructuredThoughts.pdf.

[4] For a more complete discussion of the proposed regulations, please see our November 1, 2015 client alert: http://www.mofo.com/~/media/Files/ClientAlert/2015/11/151101tlac.pdf

[5] For more information about survivor option provisions, please see our October 15, 2015 issue of Structured Thoughts: http://www.mofo.com/~/media/Files/Newsletter/2015/10/151015StructuredThoughts.pdf.

A Way Forward for Structured Notes?

The principal issue that bank regulators have raised concerning structured notes is that the securities are difficult to value. This valuation difficulty makes it challenging for the banking agency that serves as the resolution authority to effectuate an orderly resolution. What if the structured notes were not difficult to value and had an agreed-upon or stipulated value upon a resolution?

This may seem an unusual suggestion, but in many cases, it would not be a dramatic change. An indenture for debt securities provides that the principal amount of notes will become immediately due and payable upon an acceleration of maturity upon the occurrence of an event of default, such as a voluntary or involuntary bankruptcy of the issuer. This provision works well in the case of a fixed or floating rate note, where the amounts due and payable are easily ascertained.

Because the amount of principal to be paid at maturity for many structured notes may be uncertain, and, consequently, the principal amount to be paid at acceleration is also uncertain, some structured note issuers have defined a "default amount."

Under this approach, upon an acceleration, holders would receive an amount equal to the cost of having a qualified financial institution expressly assume all of the issuer's payment and other obligations with respect to the notes as of the date of acceleration and as if no default or acceleration had occurred, or to undertake other obligations providing substantially equivalent economic value to the holder with respect to its notes, less the costs to such institution for the assumption. Qualified financial institutions, which are highly rated U.S., European or Japanese financial institutions, would submit bids to assume the notes. The concept behind the default amount is that, during times when the markets are volatile, a truer value for the accelerated notes would be obtained by using an unaffiliated financial institution's valuation, subject to objection to that valuation by the holders. Needless to say, it is likely that the default amount would be less than the principal amount of the notes. Mechanically, the default amount process generally works like this:

- If there is an acceleration, the note goes out for bid by a qualified financial institution;
- If any bids come in, the lowest amount will be used;
- The bid period starts on the day the acceleration amount comes due and continues for three business days;
- If there are no quotes, or all quotes are objected to by an objecting party, then the bid period extends until the third business day after a new bid is obtained; and
- The objecting party must do so in writing, in which case the bid will be disregarded.

If objections continue until the final valuation date, then the default amount will be the principal amount. In other words, if the note holders and the qualified financial institution(s) cannot agree on the value of the notes, the principal amount will be the amount due upon acceleration. The default amount method presents holders of accelerated notes with a choice. If bids are too low, holders have the option of objecting until the final valuation date in order to get the principal amount. If bids are not so low and the final valuation date is far in the future, the holders will need to consider the time value of money in deciding if it is worth it to continue objecting to the bids.

Of course, this default amount concept as currently used would not be practicable in the case of an orderly resolution, which is intended to take place quickly over the course of a weekend. However, inclusion of the default amount in a substantial number of outstanding structured notes seems to suggest that market participants accept in principle the notion of a stipulated value being ascribed to their structured notes upon the occurrence of a default.

Taking this a step farther, what if structured notes included a "resolution amount" or a "settlement amount" that was a stated amount that would be paid to the holder of the note in a resolution? This would provide certainty for the resolution authority. An investor in such a structured note would not be in a position very different from that of a holder of a contingent capital security or even than that of a holder of a fixed rate note of a G-SIB.

Issuers of structured notes that are G-SIBs have a number of other issuance alternatives available to them. They can offer market-linked certificates of deposit. They can offer structured notes that are issued by their subsidiary banks or by their bank branches. They can establish finance subsidiaries or subsidiaries that are capitalized and have these subsidiaries issue structured notes that are guaranteed by the parent bank holding company (provided that the guarantee

does not provide for payment acceleration upon the failure of the bank holding company). They can continue issuing an array of rate-linked notes. Why not add to the possibilities a fixed resolution amount structured note?

FSB Releases Final TLAC Principles

On November 9 2015, the Financial Stability Board (FSB) published its final principles on the loss-absorbing and recapitalization capacity of global systemically important banks (G-SIBs) in resolution, together with a final version of its term sheet for total loss-absorbing capacity (TLAC). Similar to the proposal of the U.S. Federal Reserve Board, the FSB's term sheet excludes "structured notes" from being counted towards TLAC. Our detailed client alert may be found at the following link: http://www.mofo.com/~/media/Files/ClientAlert/2015/11/151109ResolutionGSIBs.pdf. We have produced a summary, which may be accessed here: http://www.mofo.com/~/media/Files/PDFs/150831TLACCheatSheet.pdf.

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Morrison & Foerster was named Best Law Firm for Derivatives – US, 2015 by GlobalCapital at its US Derivatives Awards.

Morrison & Foerster has been named Structured Products Firm of the Year, Americas by *Structured Products* magazine six times in the last ten years. Morrison & Foerster was named Best Law Firm in the Americas, 2012, 2013, 2014 and 2015 by *Structured Retail Products.com*.

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