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Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

SEC Rolls Out "POSITIER"

The SEC's Office of the Investor Advocate used a recent March 9, 2017 open meeting and related "Evidence Summit" to announce its new investor research initiative, "POSITIER."[1] This new acronym represents: **P**olicy **O**riented **S**takeholder and **I**nvestor **T**esting for **I**nnovative and **E**ffective **R**egulation. A summary of the initiative can be found at the following link on the SEC website: https://www.sec.gov/spotlight/investor-advisory-committee-2012/scholl-slides-iac-030917.pdf.

The initiative represents a response to two themes that have frequently arisen in connection with the subject of securities regulation: (a) are U.S. securities laws and regulations appropriately tailored to meet investor needs; and (b) do the investor protection aspects of these laws and regulations justify the costs that they impose? Both questions are top of mind for participants in the structured products market who expend significant efforts to make their disclosure documents and other marketing materials user-friendly for retail investors.

At the March 9, 2017 open meeting, panelists addressed the recurring perceived problem that a significant portion of U.S. retail investors do not have the skills and experience to understand and evaluate important disclosures in investment documents such as prospectuses.[2]

[1] According to Brian Scholl, Principal Economic Advisor and Senior Economist, of the Office of the Investor Advocate, this term should be pronounced to rhyme with the word "Musketeer."
[2] These panelists included Gary Mottola, Research Director, of the FINRA Investor Education Foundation, Professor Annamaria Lusardi, Academic Director, of the Global Financial Literacy Excellence Center (GFLEC), and Denit Trust, Distinguished Scholar & Professor of Economics and Accountancy, of the George Washington University School of Business.

POSITIER represents a new formal infrastructure and investor research initiative led by the Office of the Investor Advocate. It is intended to test the effects of policies on investors before their roll out, with a view to promoting evidence-driven policy making.

According to Mr. Scholl, POSITIER's mission is to:

- Change the way the SEC conducts its rulemaking.
- Reflect the needs of current and potential investors.
- Provide actionable policy implications.

Mr. Scholl indicates that POSITIER will pursue these goals by seeking to ensure that voices of investors are integrated into the rulemaking process. POSITIER will use new technology, administrative data, survey data, and qualitative data to support its analysis. POSITIER will test potential regulations and conduct an ex-ante analysis of questions about workability of regulations.

Mr. Scholl indicates that POSITIER is not designed to increase or introduce new regulations. Rather, it may provide evidence that could relax or remove regulations, for example, where existing regulations are determined not to be helpful. He indicated that the primary question is not "do investors say they want a particular piece of information or type of disclosure?", but "would providing this information affect investor outcomes and lead to better decision making?"

PRIIPS Update: EU Commission Adopts Revised RTS

On March 8, 2017, the European Commission adopted and published a revised Delegated Regulation relating to the Regulation on Key Information Documents (KIDs) for packaged retail and insurance-based investment products (PRIIPs).

Background

The EU Commission had adopted the previous version of the Delegated Regulation in June 2016. The Delegated Regulation sets out detailed Regulatory Technical Standards (RTS) in relation to the content of the KID that manufacturers of PRIIPs are required to prepare under the PRIIPs Regulation and provide to retail investors, prior to any sale of a PRIIP, to those investors. Market participants and trade associations raised concerns about various aspects of the initial Delegated Regulation, and it was rejected by the European Parliament in September 2016. The EU Commission subsequently agreed to delay the implementation date of the PRIIPs Regulation by one year, to January 2018, so that the RTS could be finalized prior to the implementation date. We discuss below the principal changes made by the revised Delegated Regulation.

Comprehension Alert

Products that are "complex" products within the meaning of the MIFID II Directive (or which, in the case of insurance-based products, provide exposure to complex products) must contain in the "General Information" section of the KID, a comprehension alert in accordance with the PRIIPs Regulation. This, therefore, provides specificity as to when a comprehension alert is required. The PRIIPs regulation is silent on this point other than stating that such an alert must be provided "when applicable."

However, this approach is likely to mean that many PRIIPs will require a comprehension alert. All derivatives or products embedding a derivative are regarded as complex under MiFID II. Any product that incorporates a structure that makes it difficult for investors to understand the associated risks, or which contains any clause, condition, or trigger that fundamentally alters the nature or risk of an investment or its payment profile, will also require a comprehension alert.

Insurance-based Products

For insurance-based products, the "What is the product" section will be required to set out a summary of either the impact of the biometric risk premium on the investment return at the end of the recommended holding period of the product or the impact of the cost element of the biometric risk premium taken into account in the recurring cost element of the "Costs over time" table required to be included in the KID. For such products, this section should also include an explanation of the impact of the insurance premium payments, equivalent to the estimated value of insurance benefits, on the returns of the investment for the retail investor.

These changes therefore seem to address one of the concerns raised by the insurance industry that the aggregation of the biometric risk premium and investment costs was misleading in the context of insurance-based products and gave a misleading impression when compared with other products.

New Performance Scenario

In the "What are the risks and what could I get in return section" of the KID, an additional performance scenario is now required. In addition to the previous favorable, moderate, and unfavorable scenarios, a "stress scenario" is also required to be included in accordance with methodology set out in Annex IV to the Delegated Regulation. For the calculation of expected values for intermediate holding periods, as was previously the case, the unfavorable, moderate, and favorable scenarios shall be the estimate of the value of the PRIIP at the start of such intermediate periods consistent with the 10th, 50th, and 90th percentiles respectively. For the stress scenario, the value is to be taken at the intermediate period consistent with the percentile level that corresponds to 1% for one year and 5% for the other holding periods of the simulated distributions in accordance with the other provisions of the RTS.

Multi-Option Products and UCITS Funds

For multi-option products, where UCITS funds (or non-UCITS funds subject to an obligation to publish a Key Investor Information Document (KIID) on the same basis as UCITS funds) are an underlying investment option, the manufacturer may, instead of complying with the requirements under the PRIIPs RTS, continue to publish a KIID meeting the requirements set out in the UCITS IV Directive until December 31, 2019.

Next Steps

The European Council of Ministers and the European Parliament must now consider the revised Delegated Regulation. The current expectation is that both these institutions will approve it well within the three-month scrutiny provided for. Once the Delegated Regulation has been adopted by the relevant institutions, it will come into force 20 days after its publication in the Official Journal of the EU. However, it will not become effective until January 1, 2018, the same date from which the PRIIPs Regulation will apply.

Observations

The amendments to the Delegated Regulation are relatively narrow. However, they do address the major concerns raised by the EU Parliament in 2016. Whether the revised version addresses all concerns raised by market participants, particularly in the insurance industry, seems more questionable. Although the EU Commission has added a stress scenario to the performance scenarios, there have been no changes to the underlying methodology used to calculate future projections and no inclusion of past performance data, which many in the insurance industry had advocated.

However, initial feedback from some members of the EU Parliament that voted against the original Delegated Regulation seems to suggest that the amendments made by the Commission, particularly the inclusion of the stress scenario, have gone a long way toward addressing their concerns. At present, it therefore seems reasonably likely that the RTS will be adopted in the form set out in the revised Delegated Regulation.

It should also be noted that European Supervisory Authorities (ESAs) are working on developing "level 3" materials, principally in the form of a Q&A, relating to technical methodologies on risk, reward, and cost disclosure requirements, calculation of costs, and the calculation of market and credit risk measures, among other issues. Although these level 3 materials were originally due to be published in mid-2016, they have been subject to significant delay. The timing is still uncertain, although market participants will hope that these are published by the end of Q2 2017 in order to give sufficient time for consideration in advance of the PRIIPs Regulation becoming effective.

T+2 Ready to Go for 2017

As discussed in our March 24, 2017 article (http://www.bdiaregulator.com/2017/03/sec-adopts-t2-settlement-cycle-for-securities-transactions/), the SEC's planned move to a T+2 settlement cycle has been approved and will apply to transactions beginning on September 5, 2017. The SEC's adopting release may be found at the following link: https://www.sec.gov/rules/final/2017/34-80295.pdf.

We previously discussed the potential impact of the T+2 settlement cycle on structured products in a January 2016 edition of this publication: https://media2.mofo.com/documents/160115structuredthoughts.pdf.

The compliance date at the beginning of September 2017 means that, for example, secondary trades of most offerings scheduled for September 2017 will be subject to the new regime. Accordingly, market participants will need to determine whether to shorten their initial settlement cycle to T+2. Alternatively, they may wish to continue to settle their transactions on their existing T+3 (or T+5 basis) and alert investors in their offering documents as to the requirements associated with any quick resale of newly issued securities, as is the present practice for offerings that settle in more than three business days. For example, Rule 15c6-1(c) provides that the shorter settlement cycle of the rule does not apply to purchase agreements arising in firm commitment public offerings that price after 4:30 Eastern time where settlement is to occur no later than the fourth business day after the contract date.

Canadian Banks and XBRL

As readers of this publication know, Canadian banks are significant issuers in the U.S. structured product market. These issuers that are SEC registrants share many of the responsibilities of all other SEC registrants, such as paying SEC filing fees and having potential liabilities under Sections 11, 12, and 17 of the Securities Act of 1933 (the "1933 Act"). However, to the extent they utilize the U.S.-Canadian multi-jurisdictional disclosure system (MJDS), they cannot obtain some of the benefits of other SEC registrants; most notably, they cannot be "well-known seasoned issuers" under the 1933 Act.

One more burden can now be added to the responsibilities of these issuers. On March 1, 2017, the SEC made available its taxonomy for issuers that prepare their financial statements in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). The SEC had previously required foreign private issuers that prepare their financial statements in accordance with IFRS as issued by the IASB to submit financial information in XBRL. However, the SEC's EDGAR filing system was not able to support an IFRS taxonomy; as a result, foreign private issuers had been relieved of the XBRL requirement until the SEC published its IFRS taxonomy.

Now that the SEC has published the IFRS taxonomy, foreign private issuers that prepare their financial statements in accordance with IFRS as issued by the IASB may begin submitting their financial data in XBRL format with their first annual report on Form 20-F (or 40-F, for MJDS issuers) for fiscal periods ending on or after December 15, 2017. Canada had previously adopted IFRS standards for most public companies for financial years beginning on or after January 1, 2011. Accordingly, this new requirement has been on the radar screen for Canadian banks for some time. Now, they will need to plan supplement their existing SEC reporting procedures to facilitate the XBRL submissions.

The SEC, Guide 3, and Bank Issuers

In March 2017, the SEC issued a request for comment relating to its Industry Guide 3, "Statistical Disclosure by Bank Holding Companies." Guide 3 applies to the disclosure of a variety of financial and statistical information that is included in the SEC filings of bank holding companies. Guide 3 was originally published in 1976 and was last updated in 1986. Accordingly, the request for comment raises a wide variety of potential disclosure issues that have arisen as time has passed.

By its terms, Guide 3 only impacts SEC filings. However, in the U.S. market, the disclosures made by non-SEC registrants, such as in the offering documents for Rule 144A programs by non-U.S. banks and bank note programs for bank issuers, reflect to some extent the practices arising from Guide 3. Over time, changes to Guide 3 may also impact how non-U.S. regulators regulate the disclosures by financial institutions in their own jurisdictions. Accordingly, changes to Guide 3 may impact the disclosures made by a significant number of participants in the U.S. structured product market.

Our detailed client alert about the request for comment can be found at the following link: https://media2.mofo.com/documents/170307-sec-issues-request-comment.pdf.

Shelf Updates and Hyperlinks

Ever since the SEC enacted its Securities Offering Reform in 2005, it has been "black letter" law in the United States that a shelf registration statement must be updated every three years. For structured product issuers, this update can be a somewhat significant undertaking, requiring updates to its base prospectus, MTN prospectus supplement, various product supplements (and any underlying supplements), and forms of red herrings and pricing supplements.

What is the magic about three years? In its 2005 adopting release for securities offering reform, the SEC indicated its reasoning for the updating requirement: "the precise contents of shelf registration statements may become difficult to identify over time, and that markets will benefit from a periodic updating and consolidation requirement." [3]

It is possible that this suggestion is somewhat antiquated and superseded by both technological developments and market practice. First, many or most frequent issuers include hyperlinks in their offering documents for shelf takedowns that make it quite easy to locate the relevant base prospectus (and/or prospectus supplement). In a more recent development, the SEC's recent rule amendments relating to exhibits to registration statements, and providing hyperlinks to those exhibits,[4] demonstrate the efficacy of hyperlinks to enable investors to obtain easy access to the information that they need.

Of course, there are many reasons to update a shelf every three years and, sometimes, more frequently. An issuer's business description may be outdated due to changes in operations or mergers or sales of different operating units. Risk factors relating to an issuer's business, or its securities, may become outdated. An issuer may develop a new approach to technical provisions, such as market disruption events, that it wishes to roll out on a consistent basis.

However, as to the core issue: making sure that investors have easy access to the most recent offering documents and issuer financial statements—hyperlinks provide a very convenient solution, and market participants are using them to help ensure that investors have access to the most up-to-date information.

FINRA Issues (Another) Investor Alert Relating to Binary Options

In March 2017, FINRA issued an Investor Alert relating to fraudulent schemes involving binary options. The alert is entitled "Binary Options Follow-Up Schemes: Don't Lose Money Twice," and may be found at the following link: http://www.finra.org/investors/alerts/binary-options-follow-schemes-dont-lose-money-twice.

According to the alert, investors with binary options accounts on suspect and potentially unlawful platforms may be targets for a variety of follow-up frauds, including:

Advance Fee: FINRA is aware of customers of a binary options platform being contacted by individuals who claim they can help the customer get back money lost in prior investments—however, the investor must pay an "advance fee" to the fraudster for the service.

IRS Impersonator: Fraudsters have phoned investors, claiming to be representatives of the IRS. The imposter then claims that the investors owe the IRS outstanding tax obligations from prior binary trading activity and must pay up promptly, often by means of a credit card, debit card, or prepaid debit card.

Of course, this is not the first time that U.S. regulators have identified scams involving binary options. For a description of prior similar circumstances, please see our November 4, 2015 issue of this publication available at: https://media2.mofo.com/documents/151104structuredthoughts.pdf.

[3] See https://www.sec.gov/rules/final/33-8591.pdf. This linked document is a rather long document. We would encourage you not to print the whole megilah unless you need to. If you need it, the reference in question is on page 212, okay?
[4] For a discussion, please see our article at the following link: http://www.mofojumpstarter.com/2017/03/02/exhibit-hyperlinks-and-html-format/.

STRUCTURED PRODUCTS 2016 At A Glance

WHAT ARE STRUCTURED PRODUCTS?

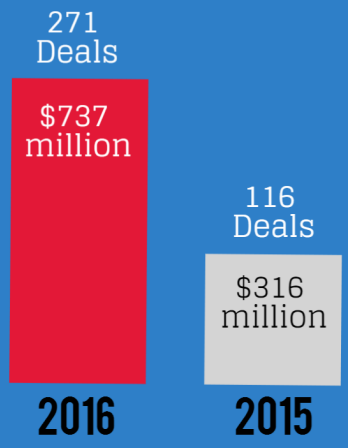
Structured products or market-linked investments are debt obligations with cash flow characteristics that depend on the performance of one or more reference assets. The prototypical structured product may be a senior note with a return based on a popular index, such as the S&P 500® Index or the Dow Jones Industrial Average℠. These products are designed by broker-dealers to meet the risk/reward needs of investors and offer distinct benefits that cannot typically be obtained from other types of investments.

$38.7 BILLION — Total Notional of Structured Product Issuances in 2016.[1] $44.1 billion was issued in 2015.

$4.1 MILLION — Average Size of Structured Product Transactions in 2016. The average in 2015 was $5.1 million.

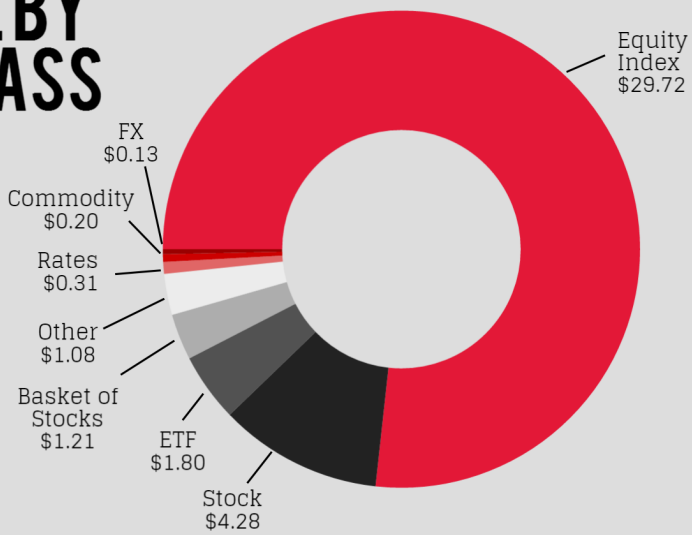
9,362 — Total Number of Structured Product Issuances in 2016. 8,567 Structured Products were issued in 2015.

PRINCIPAL PROTECTED NOTES WITH UPSIDE PARTICIPATION[2]



ISSUANCE BY ASSET CLASS IN 2016

(in $ billions)



- Equity Index (76.74%)
- Stock (11.05%)
- ETF (4.65%)
- Basket of Stocks (3.12%)
- Other (2.79%)
- Rates,[3] such as CPI & CMS (0.80%)
- Commodity (0.52%)
- FX (0.34%)

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For more information about Structured Notes, please visit: www.mofo.com/structured-products-services

1- Includes U.S. structured notes registered with the Securities and Exchange Commission in 2016. Excludes plain-vanilla, lightly structured notes such as "step ups", fixed-to-floating notes and capped floaters.
2 - Does not include lightly structured rate-linked notes, such as step-up callables.
3 - Does not include lightly structured rate-linked notes.

Source: Prospect News

Haiku Corner

A Brief Meditation on a Buffer

My buffer was breached

But it's worse than even that

Darned downside gearing

Upcoming Events

U.S. and Other Non-EU Issuers Offering Securities in Europe: Update on Legal and Regulatory Developments
Wednesday, April 19, 2017
Morrison & Foerster Teleconference, 12:00 p.m. – 1:00 p.m. EDT

Partner Peter Green and Partner Jeremy Jennings-Mares will host a session regarding some of the recent and forthcoming regulatory developments in the EU that are likely to have particular impact for non-EU issuers of securities offering into the EU.

For more information, or to register for the conference, please click here.
CLE credit is pending for California and New York.

TLAC & MREL 2017
Center for Financial Professionals Conference
Tuesday, April 25 – Wednesday, April 26, 2017
Morrison & Foerster Sponsorship

The TLAC & MREL 2017 conference will focus on assessing constraints and opportunities ahead of TLAC & MREL final rule, implementation and constrictions.

Partner Peter Green and Partner Jeremy Jennings-Mares will speak on a panel entitled "Considerations for Proposed Subordination Rules: Cost, Variations and Impacts" on day one of the conference.

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

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.

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

Morrison & Foerster is currently nominated for Americas Law Firm of the Year – Overall; US Law Firm of the Year – Transactions and US Law Firm of the Year – Regulatory for *GlobalCapital's* 2017 Americas Derivatives Awards. We were named Americas Law Firm of the Year in 2015 and 2016 by *GlobalCapital* for its Americas Derivatives Awards.

Morrison & Foerster was named 2016 Global Law Firm of the Year by *GlobalCapital* for its Global Derivatives Awards.

Morrison & Foerster was named the 2016 Equity Derivatives Law Firm of the Year at the *EQDerivatives* Global Equity & Volatility Derivatives Awards.

Morrison & Foerster has been named Structured Products Firm of the Year, Americas by *Structured Products* magazine seven times in the last 11 years.

Morrison & Foerster was named Best Law Firm in the Americas four out of the last five years by *StructuredRetailProducts.com*.

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, and Fortune 100, technology and life sciences companies. We've been included on *The American Lawyer*'s A-List for 13 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.