

# Structured Thoughts

*News for the financial services community.*



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## **Index Changes and Successor Indices: Avoiding Delisting from the NYSE Arca**

Down deep, somewhere in the boilerplate in the back of a prospectus for an index-linked note, you can find the provisions for index adjustments and successor indices. These standard provisions are sometimes given only a cursory glance when drafting a disclosure document. Index changes or discontinuances are rare, and even more rarely occupy much real estate in the mind of the draftsman. There may be a rude awakening in store, however, for that inattentive draftsman if the note is listed on the NYSE Arca.

### **Index Changes and Substitutions**

What happens if the index sponsor makes a material change to the underlying index, or if the underlying index is no longer published and has to be replaced? In the event of a material change to the index that, in the opinion of the note calculation agent, causes the underlying index to no longer fairly represent the level that the index would have had if that change had not been made, most structured notes provide that the note calculation agent will make adjustments, in its discretion, to determine the level of the index. These adjustments are intended to adjust the closing level of the revised index as if the modifications to the index had not been made.

If the index sponsor ceases to publish the index, and the index publisher – or a separate entity – publishes a substitute index that, in the discretion of the note calculation agent, is comparable to the original index, then most notes provide that the new successor index will be substituted for the original index.

## NYSE Arca Rules

All is well, unless the structured note is a listed "Structured Product," as that term is defined in NYSE Arca Equity Rule 5.1(b)(17), or a listed "Derivative Securities Product," as that term is defined in NYSE Arca Equity Rule 5.2(j)(3), Commentary .01(a)(A)(1). As examples, an exchange traded note linked to an index of equity securities and listed under NYSE Arca Equity Rule 5.2(j)(6) would be a Structured Product, and an Investment Company Unit listed under NYSE Arca Equity Rule 5.2(j)(3) would be a Derivative Securities Product. Issuers of structured products that fall into either of those two categories should consider NYSE Arca Equity Rule 5.3(i)(1)(i)(P), and consult with the NYSE if they are informed by the index sponsor of a potential future change to the index.

NYSE Arca Equity Rule 5.3(i)(1)(i)(P) requires a minimum 10-business-day advance notice (which may be made by telephone or email) to the exchange by the issuer if any of the following "Material Index or Portfolio Changes" to an underlying index or portfolio of securities are scheduled to occur:

- the value of the index or portfolio is no longer calculated or available and a new index or portfolio is substituted;
- the index or portfolio is replaced with a new index or portfolio from the same or a different index provider; or
- the index or portfolio is significantly modified (including, but not limited to, a significant modification to the index methodology, a change in the index provider or a change in control of the index provider).

A prospective change that constitutes a Material Index or Portfolio Change likely would require the issuer to submit to the NYSE a supplemental listing application, as well as a certified copy of the board resolution authorizing the change; such a change may also require the issuer to make a public announcement of the change by means of a press release, as provided by NYSE Arca Equity Rule 5.3(i)(2)(viii) (Immediate Public Disclosure of Material Information). If the prospective Material Index or Portfolio Change would cause the underlying index to no longer meet the NYSE Arca's generic listing standards, which are set forth in NYSE Arca Equities Rule 5.2(j)(6), then, in order for the structured product to remain listed, a rule filing under Section 19(b)(2) of the Securities Exchange Act of 1934 would be required. Given that a 19(b)(2) filing is generally an extremely lengthy (and potentially expensive) process, if the prospective change is scheduled to take place prior to SEC approval of the 19(b)(2) filing, then the NYSE would direct that trading in the structured product be halted on the date of the change. If it becomes clear to the NYSE that the 19(b)(2) filing will not be approved or will not become effective, or the NYSE decides to withdraw the 19(b)(2) filing, then the NYSE will delist the note.<sup>1</sup>

## Steps to Be Taken

Consequently, if the issuer of a listed Structured Product or Derivative Securities Product learns that an index sponsor or provider is contemplating a change to its methodology, it would be advantageous for that issuer to contact the NYSE Arca as early as possible to discuss the potential change, and to plan accordingly if the NYSE Arca would view the potential change as material.

Issuers of listed Structured Products may want to consider adding some extra language to the index adjustments and successor index disclosures in their prospectuses. For example, a typical exchange traded note is callable at any time from six months to one year after its initial issuance. An issuer could also include, either in a risk factor or in the index adjustment section, disclosure that any index adjustment or substitution could cause the note to be delisted. In that event, it is likely that the issuer would call the exchange traded note, and investors could be so informed in the prospectus.

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<sup>1</sup> The NYSE Arca's guidance on Rule 5.3(i)(1)(i)(P) can be found at: [https://www.nyse.com/publicdocs/nyse/listing/index\\_change\\_guidance\\_letter\\_08\\_22\\_2013.pdf](https://www.nyse.com/publicdocs/nyse/listing/index_change_guidance_letter_08_22_2013.pdf).

## EU PRIIPs Regulation Expected to Come Into Force

On October 24, 2014, the EU Council published what is expected to be the final text of the EU Regulation on key information documents (KIDs) for packaged retail and insurance-based investment products (PRIIPs). This draft reflects the position adopted by the EU Parliament in April this year following a lengthy and, at times, difficult legislative process. It is expected this draft will be formally approved by the EU Council shortly, following which it will be published in the *Official Journal of the European Union* and come into force 20 days after that day. The provisions of the Regulation will not, however, become effective until two years after it comes into force.

Under the Regulation, when a person is advising on or selling a PRIIP to retail investors, a KID must be provided to the investor prior to any contract being concluded. The primary obligation to draw up the KID will be on the manufacturer of the PRIIP (including any entity that makes significant changes to an existing PRIIP). The Regulation contains detailed requirements as to the form and content of the KID, which must be a maximum of three sides of A4 paper. The KID should be a “stand-alone” document separate from marketing materials, and must contain key information relating to the product. Although key information is not defined, an explanatory statement to be included in the KID will state that the information is intended to help the investor understand the nature, risks, costs, and potential gains and losses of the product and help with comparison with other products.

Although the KID requirements will have a significant impact on the structured products industry in the EU, many of the concerns highlighted by the industry in the consultations during the legislative process were reflected at least some extent in the final Regulation, and some of the proposals which gave the industry most concern were not included in the final text. In particular:

- the proposal for a “complexity label” was dropped and replaced with a “comprehension alert” (which must notify investors that the product is not simple and may be difficult to understand);
- there is no requirement for an “on-line calculator”;
- there is no reversal of the burden of proof in the liability provisions; and
- there is no prohibition on the preparation of a KID for certain types of complex products (which would have effectively banned such products for retail investors).

In addition, previous proposals to include specific product intervention powers for national and European authorities have been dropped (except in relation to insurance-based PRIIPs), and are now dealt with exclusively in the MiFID II legislation.

The European Parliament had also proposed the extension of the requirement to publish a KID to a wider range of investment products. This is not reflected in the final Regulation; however, the EU Commission must review the Regulation within four years, including as to its possible extension to other products. It is possible the review may also revisit some of the other issues highlighted above.

## UK Review of the Fixed Income, Currency and Commodities (FICC) Markets

In October 2014, the UK Treasury, the Bank of England and the Financial Conduct Authority launched a public consultation to examine the fairness and effectiveness of the FICC markets. This consultation was launched in the wake of recent high-profile market abuses, such as the attempted manipulation of LIBOR and other benchmarks. The three regulators (terming themselves the “Fair and Efficient Market Review” or the “Review”) acknowledge that there has already been a significant industry and regulatory response to these various market abuses but consider there is a need to assess whether the changes and action implemented have gone far enough to restore confidence in the FICC markets.

The Review considers that “effective” FICC markets are those that enable market participants to trade at competitive prices and allow the ultimate end users to undertake investment, funding, risk transfer and other transactions in a predictable fashion.

“Fair” markets are those that:

- have clear and consistently applied standards of market practice;
- demonstrate sufficient transparency and open access;
- allow market participants to compete on the basis of merit; and
- provide confidence that participants will behave with integrity.

Based upon those premises, the Review will focus on structural features that may have facilitated recent abuses, such as the greater ease of manipulation in markets for bespoke products that are rarely traded, as well as conflicts of interests, limited transparency and market concentration.

In addition, it will also consider issues of market conduct, including:

- poor standards of market practice and personal ethics;
- weak cultures of accountability, poor controls and inappropriate remuneration structures within firms; and
- poor benchmark governance and transparency.

Lastly, it will also consider concerns expressed by market participants about the potential resilience of liquidity in post-crisis FICC markets.

Based upon these different sub-categories, the Review is seeking views firstly on the extent to which regulatory, organizational and technological changes since the financial crisis are likely to address any perceived deficiencies in fairness and effectiveness, and secondly what further steps might be needed to help boost fairness and effectiveness in particular FICC markets.

The consultation is open for responses until 30 January 2015, and the Review plans to publish its recommendations in June 2015.

## **FINRA and the SEC Focus on Structured Products and Alternative Funds at Complex Products Industry Forum**

In October 2014, in a speech at the SIFMA Complex Products Forum, Susan Axelrod, FINRA's Executive Vice President of Regulatory Operations, reported a number of FINRA's concerns that impact the structured products industry. A copy of her speech may be found at the following link: <http://www.finra.org/Newsroom/Speeches/Axelrod/P601434>.

Ms. Axelrod noted that in the present low interest rate environment, many retail investors have been purchasing more complex instruments in their search for yield, including structured products. In her speech, she focused in particular on rate-sensitive instruments, including curve steepeners and range accrual notes.

In particular, Ms. Axelrod noted: "First, firms that are going to make complex products available to customers have a duty to make sure investors fully understand how the products operate and the risks of each product. That begins with brokers having a full understanding of the products they sell and receiving training on the features of the product as well as their firm's own suitability guidelines for the products. Brokers should understand whether a particular product is suitable for a particular client. When we examine firms, we also review the training provided to brokers to determine whether they understand the products they recommend. Having a full understanding of a product can help a broker conduct proactive conversations with his or her customer about product-specific risks."

In a related speech, Norm Champ, the SEC's Director of the Division of Investment Management, spoke about how his industry is addressing complex funds being sold to retail investors. A copy of his speech may be found at: <http://www.sec.gov/News/Speech/Detail/Speech/1370543319219>. Mr. Champ paid particular attention to the risks posed by alternative funds, and their significant recent growth. Disclosures of their strategies, risks, and holdings remains a principal concern, particularly the possibility of a disconnect between the strategies disclosed in a prospectus, and the strategies that a fund actually employs.

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## **Referral Fees and Sharing Commissions in Structured Note Sales**

In September 2014, FINRA proposed rule changes addressing when broker-dealers may pay referral fees or share their compensation with parties other than registered broker-dealers. Our firm's client alert relating to the proposed rules may be found at the following link: <http://www.mofo.com/~media/Files/ClientAlert/2014/10/141016ReferralFees.pdf>.

The proposed amendments are relevant to those sales of structured notes that involve a proposed referral fee or other compensation to a non-FINRA member. For example, a non-U.S. firm may seek compensation from a U.S. underwriter in connection with an account opening, or sales of particular instruments.

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## Conference: Structured Products Europe 2014

Join Morrison & Foerster on November 18, 2014, at the 10th Annual Structured Products Europe conference. The event will be held at the Hilton London Tower Bridge hotel. The event will bring together top UK and European senior executives from investment banks, regulators, private bankers, issuers, index providers, asset managers, IFAs, pension funds and insurance companies, and will provide a unique opportunity to convene and discuss the most pressing issues in the structured products Pan-European market. The conference seeks to provide in-depth and cutting-edge market knowledge alongside invaluable working opportunities. This year promises to bring renowned speakers within the business who will provide insight on European securities laws and main regulatory changes that impact the structured products industry. Product innovation and investment strategies, distributors' concerns and risk management will be discussed.

For additional information, and conference reservations, visit the following page:  
<http://www.structuredproductseurope.com/static/home>.

MoFo partners Peter Green and Jeremy Jennings-Mares will speak on "Regulatory Developments in the EU and UK." Topics of this boot camp style discussion will include:

- MiFID II - effect of the rules relating to transparency for certain structured products, exchange trading of derivatives and product intervention;
- Finalization of UCITS V and possible UCITS VI;
- Ongoing effect of amendments to the Prospectus Directive;
- Regulators' views generally on "complex" products; and
- Overview of the regulatory approach in individual EU jurisdictions and a look at developments in the U.S. and Asia.

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## Seminar: Master Class: ETNs

Join Morrison & Foerster on November 20, 2014, for a one hour CLE session titled "Master Class: ETNs." The event will be held at Morrison & Foerster's New York offices. Led by Of Counsel Bradley Berman, this seminar will focus on Exchange Traded Notes and will delve into timely issues for structured products market participants. Topics of discussion will include:

- NYSE Arca listing requirements – summarizing the differing requirements for ETNs linked to equity indices, commodity indices and other permissible underliers;
- Regulatory issues – the iPath no-action letter and relief from Regulation M for dealer market making activities and issuer redemptions;
- ETNs in the news – some exchange traded notes have drawn negative attention in the press;
- Recent SEC and FINRA guidance on ETNs – what has FINRA and the SEC said lately about ETNs, and a summary of the SEC's ETN sweep letter; and
- Drafting issues.

For more information about this event, or to register, [click here](#).

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

Morrison & Foerster has been named **Structured Products Firm of the Year, Americas, 2014** by *Structured Products* magazine for the sixth time in the last nine years. See the write-up at <http://www.mofo.com/files/Uploads/Images/120530-Americas-Awards.pdf>. Morrison & Foerster named **Best Law Firm in the Americas, 2012, 2013, and 2014** by *Structured Retail Products.com*.

Morrison & Foerster named **Legal Leader, 2013** by *mtn-i* at its Americas Awards. Several of our 2013 transactions were also granted awards of their own as a result of their innovation.

Morrison & Foerster named **European Law Firm of the Year, 2013** by *Derivatives Week* at its Global Derivatives Awards.

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**About Morrison & Foerster**

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life sciences companies. We've been included on *The American Lawyer's* A-List for 11 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at [www.mofo.com](http://www.mofo.com). © 2014 Morrison & Foerster LLP. All rights reserved.

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