Morrison & Foerster News Bulletin Volume 9, Issue 1 February 2, 2018

Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Special Announcement from Morrison & Foerster and the Structured Products Association

As of January 1, 2018, Morrison & Foerster has provided the Structured Products Association (SPA) a free license to republish all *Structured Thoughts* issues for the benefit of the structured products industry. All past and future issues of *Structured Thoughts* will now also be available on the SPA's website, as part of an effort to make accessible more educational content to the market.

Linking to ETFs vs. Linking to Indices

A person studying structured products issuances for the first time might think he is having a case of double vision. On the one hand, there are a variety of products linked to certain well known equity indices. On the other hand, there are other products, with fairly comparable economic terms that are linked to an exchange traded fund, or ETF, that tracks the same index.

Why the "duplication"? This article discusses some of the considerations that product manufacturers must address when considering whether to structure a product that references the performance of an index or to reference the performance of a related ETF.

Hedging Considerations. As is the case with most structured products, the issuer and/or its affiliates seek to enter into one or more hedging transactions to address the market risk created as a result of the issuance of the structured product. In the case of an ETF-linked product, it will often be somewhat easier to enter into a hedging transaction through transactions in the ETF itself, since the ETF is traded on a national securities exchange and shares of an ETF are usually easily bought and sold. By contrast, an index, in and of itself, is not a traded instrument; the issuer will need to look to a different method to hedge its potential exposure, including options on the index or, in the case of a narrow index, potentially transacting in the index constituents.

ETF Fees. In the ordinary course, an ETF will slightly underperform its underlying index. This is because there will be a variety of fees and expenses associated with an ETF, including the management fee paid to the fund's investment adviser, and the expenses associated with shareholder communications. These fees are indirectly paid by shareholders in the ETF, and result in a small decrease in the ETF prices. As a result, in theory, an ETF-linked product may need to offer a slightly higher return to investors in order to offset the impact of these fees.

License Fees and License Agreements. Conversely, an issuer that seeks to link a structured product to an index will require a license agreement with the index provider.[1] The index provider will charge a license fee to the issuer, which is a cost of issuing the product, and this fee will reduce, to some extent, the returns potentially generated by the product.

In some cases, the issuer will not have yet obtained a license agreement with the relevant index provider, or does not have time to negotiate one within the time that an investor seeks to purchase a structured product. In this case, linking to the related ETF, which does not typically require a license agreement, may be most efficient.

Eligibility as an Underlying Asset. Securities of an ETF are registered under the Exchange Act. Accordingly, market practice is only to link to those ETFs that satisfy the standards articulated by the Morgan Stanley "reading room" SEC no-action letter.[2] However, an index, in and of itself, need not satisfy the requirements of this letter. Of course, depending on the nature of the index, any fees associated with it, and any other significant risks, such as a lack of performance history, there may be a number of disclosure issues to consider.

Tracking Error. While ETFs are designed to track the referenced index, history has shown that this does not always occur as planned. As many readers of this publication will remember, on August 24, 2015, a number of important ETFs significantly declined in value compared to the value of the indices and stocks that they tracked.[3] Events of this kind, if they occur over time, or on a single key valuation date or observation date in the life of a structured note, may cause an ETF-linked product to pay out significantly different amounts to investors than a product linked to the related index.

ETF Descriptions. What is an appropriate level of disclosure in a pricing supplement for an ETF? To the extent that an ETF is subject to the reading-room letter discussed above, a very brief description of the ETF's "business" should be sufficient. However, a quick look at structured product pricing supplements makes it clear that this is far from the market practice. Rather, issuers tend to describe the underlying index to virtually the same extent as they would in the case of a product linked to that index, together with a brief description of the ETF, its sponsor and the nature of its operations. Additional disclosures may include, for example, a summary of annual expenses. As a result of this practice, when taken together with the fairly market-standard risk factors relating to ETFs generally, the offering documents for ETF-linked products will tend to be somewhat longer, and include more technical information, than products linked to the underlying index.

A Rule 424(b) Primer for the Structured Note Market

Rule 424(b) is a key means through which the SEC ensures that red herrings and final pricing supplements are publicly filed, so that they will be available to investors (and potentially subject to SEC review) on the SEC's website.

In a nutshell, Rule 424(b) requires issuers to file their red herrings (but not their red herrings styled as Rule 433 FWPs[4]) and final pricing supplements within two business days of their first use, or in the case of a final pricing supplement, within

[1] We discuss a variety of considerations relating to index license agreements in the November 4, 2015 issue of this publication, which is available at the following link: https://goo.gl/JMDFio.
[2] The text of this letter may be found at the following link: https://goo.gl/8HQt9T. In addition, for example, representatives of the SEC's Office of Capital Market Trends have expressed the view, from time to time, that actively managed ETFs should not be eligible underlying reference assets for SEC-registered structured notes. See https://goo.gl/JrMLub.
[3] See "What the E-T-F Happened on August 24?" *Forbes.com*, available at: https://goo.gl/3A1Grs.
[4] See our related article, "Structured Product Red Herrings: Rule 433 and Rule 424(b)," which is available in the December 2017 issue of this publication: https://goo.gl/1LBoub.

two business days of pricing. A pricing supplement filed with the SEC must indicate the sub-paragraph of Rule 424(b) pursuant to which the filing is made, and the filing must be electronically tagged with that information.

Practitioners (and financial printers) have spent quite a bit of time trying to decipher which prong of Rule 424(b) applies to which types of structured product offering documents. The following chart attempts to provide a summary. It being understood that market practice varies.

Clause	When Used	Typical Structured Note Offering Documents
Rule 424(b)(2)	Primary offering of securities pursuant to Rule 415(a)(1)(x) (shelf takedowns), and the document discloses information previously omitted from the prospectus filed as part of an effective registration statement in reliance on Rule 430B.[5]	Preliminary and final pricing supplements.
Rule 424(b)(3)	Pricing supplement that reflects facts or events other than those covered in, for example, Rule 424(b), that constitute a substantive change from, or an addition to, the information set forth in the last form of prospectus filed with the SEC.	Product supplements and index supplements. Also frequently used for MTN prospectus supplements.
Rule 424(b)(5)	A form of prospectus that discloses information, facts or events covered in both Rules 424(b)(2) and (3).	Often used for product supplements and index supplements.
Rule 424(b)(8)	Used for late filings.	Any of the above when not filed within the required timeframe.[6]

FINRA's 2017 Examination Findings and Structured Products

In December 2017, FINRA issued a report highlighting several key findings from its recent examinations of member firms. FINRA's report includes a number of findings relevant to market participants in the structured products industry.

In particular:

> "*FINRA found that some firms failed to meet their suitability obligations with respect to individual customers when recommending…complex products. For example, FINRA observed situations where firms …recommended a complex product without a reasonable basis to believe the product was suitable in light of the customer's risk tolerance and investment time horizon. In some instances, firms also failed to seek to obtain key pieces of investor profile information, without providing a reasonable basis for failing to do so. In addition, FINRA observed that some firms failed to establish and implement adequate supervisory systems and written supervisory procedures with regard to…complex products.*"

[5] Rule 430B permits a registration statement to exclude, for example, information that is unknown or not reasonably available to the issuer, the plan of distribution, and a description of the specific terms of the securities.
[6] A late Exchange Act report filing can have negative consequences for the issuer, including the loss of Form S-3/F-3 eligibility. A late Rule 424(b) filing does not have the same consequences under the SEC rules. However, market participants work hard to ensure timely filing of these documents, particularly since the adoption of Rule 424(b)(8) made it easier for the SEC to identify late filings.

FINRA's concerns in this area relate in part to related issues involving training and supervision:

> "*Some firms failed to provide adequate training for registered representatives with respect to suitability issues, particularly regarding the products described above. Consequently, they were neither sufficiently knowledgeable to make customer-specific suitability determinations nor to advise customers effectively on the risks those products entailed.*"

For our firm's more detailed summary of FINRA's exam findings, please see the following article: https://goo.gl/vLj4X1. FINRA remains concerned about issues of suitability and training in connection with sales of complex products.

The Credit Roundtable Proposes New LIBOR Fallbacks

Institutional Investor recently posted on its website a letter to the Board of Governors of the Federal Reserve System from the Credit Roundtable.[7] The Credit Roundtable letter (the "LIBOR Letter") proposes an alternative to the current LIBOR fallbacks and seeks to mitigate the possibility that many LIBOR instruments may become fixed rate notes after 2021.[8]

The current LIBOR mechanism included in many floating rate debt instruments, including fixed to floating rate notes, provides that if LIBOR is not published on the appropriate Reuters screen page, then, under the first fallback provision, the calculation agent will, in the case of U.S. dollar LIBOR, poll banks in the London interbank market for rates for deposits of the same tenor and currency. If that poll fails to produce at least two quotations, then, under the second fallback provision, the calculation agent would poll major banks in New York City for quotes for loans of the same tenor and the same currency offered to leading European banks. If the second poll fails to produce at least two quotations, then, under the final fallback provision, LIBOR will remain the same as in the previous interest period.[9]

As one might imagine, if LIBOR hasn't been published in the normal manner, it is highly unlikely that a rate-submitting bank would provide a quote to a calculation agent calling up on the phone. As the LIBOR Letter points out, the end result of the failure of the polls and the application of the final fallback mechanism would be that a floating rate debt instrument would become a fixed rate debt instrument. According to data quoted in the LIBOR Letter, without taking any action to address the current LIBOR fallbacks, approximately $68.51 billion of investment grade floating rate debt and $55.68 billion of U.S. bank TLAC debt would become fixed rate debt after LIBOR ceases publication.

The Proposed Fallback Mechanism

The LIBOR Letter looks to certain milestone dates and then proposes the use of an alternative rate. The key milestone dates are the earlier of the date set by the U.K. Financial Conduct Authority (the FCA) for the discontinuance of LIBOR, the date set by the LIBOR administrator (currently, Intercontinental Exchange Benchmark Administration, or "ICE") on which LIBOR will no longer be published or the date of a notice by the calculation agent to the issuer and the note holders that LIBOR has been permanently discontinued or is no longer in effect. The notice or statement by the FCA or ICE must not have been rescinded or revoked.

In that event, the new base rate for the floating rate debt would become the Secured Overnight Financing Rate (SOFR) (or any successor). Because SOFR is a secured, backward-looking overnight financing rate and LIBOR is a forward-looking, unsecured rate with various tenors, the LIBOR Letter allows for adjustments to SOFR in the form of a risk spread and a forward-looking term structure quoted by the Federal Reserve Bank of New York (FRBNY) or another entity designated by the Alternative Rates Reference Committee (ARRC) or ISDA.[10,11]

---

[7] The Credit Roundtable letter, dated January 2018, can be found at: https://goo.gl/2zNv3m.

[8] On July 27, 2017, the U.K. Financial Conduct Authority announced that the LIBOR rate would be phased out after 2021.

[9] The first two fallbacks come from USD-LIBOR-Reference Banks in the 2006 ISDA Definitions; the final fallback is not included in the 2006 ISDA Definitions, and is based on market practice. The final fallback, as presented in the LIBOR Letter, is not in all floating rate debt governing instruments. One alternative final fallback allows calculation agent discretion in setting the rate for the new interest period after the failure of the first two fallback provisions.

[10] In response to calls from regulators to identify a "risk-free" replacement for USD LIBOR, the ARRC selected on June 22, 2017 SOFR as an alternative to USD LIBOR. The ARRC was convened in November 2014 by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") and the FRBNY. On December 12, 2017, the Federal Reserve Board announced the publication of three new rates by the FRBNY, including SOFR. 82 Fed. Reg. 58397 (2017).

[11] We discussed recent LIBOR developments and the identification of replacement rates in Vol. 8, Issue 7 of Structured Thoughts, available at: https://goo.gl/vCtg9Z.

Note holders representing a majority of the outstanding principal amount may object to the new base rate by notifying the trustee no later than five business days prior to the first interest period commencing after any of the three milestone dates. In that case, the rate in effect in the previous interest period will continue into all subsequent interest periods (*i.e.*, the holders will have chosen to keep the note at a fixed rate) until the note holders either rescind their notice or unanimously consent to the new base rate.

The LIBOR Letter anticipates potential problems with SOFR as a LIBOR replacement and provides that the original LIBOR final fallback will apply if any of the following events have occurred *and are continuing*:

- The ARRC has published data establishing that the average daily difference between 3-month LIBOR and SOFR with a 3-month forward-looking term structure and a risk spread, for the 6-month period immediately prior to the milestone date, was greater than 0.01%;
- Neither the ARRC or ISDA has published a standard methodology to calculate a forward-looking term structure and a risk spread for SOFR; or
- ISDA has not replaced LIBOR with SOFR, including a forward-looking term structure and a risk spread, in its standard documentation for swaps and derivatives.

If any of these three events have occurred *but are not continuing*, then, under the new final fallback, the new base rate will be SOFR (subject to objection by a majority in outstanding principal amount of the note holders, as discussed above).

As an alternative, after any of the milestones dates, the calculation agent is authorized to choose a replacement rate for LIBOR, including SOFR, but only if the calculation agent has delivered a certification that, during the 6-month period prior to the certification, the new base rate is in use by 66% of floating rate notes issued by companies included in the S&P 500, and the average daily difference between the new base rate and the base rate in effect prior to that date (using comparable interest periods) is less than or equal to 0.01%.

The calculation agent is subject to certain standards; it must be an independent investment banking or commercial banking institution, other than the issuer or any of its affiliates, of “international standing” appointed by the issuer. The issuer can change the calculation agent, but only with the consent of a majority in outstanding principal amount of the notes.

The LIBOR Letter also provides that the calculation agent is authorized to amend the indenture, without the consent of any holder or the issuer, in order to cure ambiguities and correct defects or inconsistencies resulting from the replacement of LIBOR with a new base rate, but solely to the extent that such amendment is not adverse in any material respect to any note holder. In practice, the indenture trustee and the issuer would be the parties to a supplemental indenture.

Outstanding Issues

The LIBOR Letter is a step in the transition from LIBOR to its replacement, but there are several issues still to be addressed.

Calculation agent discretion and potential associated liability. Since the announcement that LIBOR will cease publication in 2021, many issuers have added a final fallback mechanism to their LIBOR definitions providing that if, at a determination date, the calculation agent determines that LIBOR has been discontinued, then it will use a substitute or successor rate that it has determined is comparable to LIBOR or, if the calculation agent determines that there is an industry-accepted successor base rate, then that successor base rate will be substituted for LIBOR.

Some third-party calculation agents (not affiliated with the issuer) have raised concerns about the degree of calculation agent discretion allowed under this fallback mechanism. In contrast to the fallback mechanism described immediately above, the LIBOR Letter removes calculation agent discretion, although it introduces uncertainty to the extent that note holders can object to the new interest rate.

Difficulty in implementing the noteholder objection provision. Note holders that object to SOFR as the new base rate must notify the trustee within a specified time period. How will the note holders know to act together to do so? Would they call a meeting? Who would pay the associated costs? It is unlikely that an issuer would agree to this provision.

Lack of an adjustment mechanism from SOFR to LIBOR. SOFR has been known to market participants for almost a year. Yet no market participant has proposed a standard methodology to calculate a forward-looking term structure and risk spread for SOFR. If market participants do not create this adjustment mechanism, then the solution proposed by the LIBOR Letter will not work.

Replacement of the calculation agent by the issuer with note holder consent. It’s hard to imagine a situation where the issuer would go to the trouble to obtain majority consent of the note holders to replace the calculation agent. In addition to the associated costs, the optics would be bad.

What about existing notes? The LIBOR Letter does not address the difficulty in amending existing LIBOR floating rate notes to include the new fallbacks. Generally, a debt indenture requires 100% consent of the note holders to change the interest rate. If SOFR is successfully adopted by issuers, a workable risk spread and a forward-looking term structure are in use and SOFR is adopted in standard ISDA swaps documentation, then obtaining that consent may be possible.

2018: Business as (Un)usual

2017 in the UK and the rest of Europe seems to have been primarily a year devoted to implementation – both of political decisions already made and of legislation that had already been enacted. On the political front, Brexit continued to dominate many conversations around EU financial services. Theories circulated that EU decisions on various equivalence and passporting provisions, intended to be based on regulatory system comparisons were being delayed for political reasons linked to the continued non-finalization of a deal on the post-Brexit relationship between the UK and the rest of the EU. After Brexit, it is likely that UK financial services entities will lose the benefit of EU financial “passports” and may need to try and utilize the existing provisions on equivalence for non-EU countries. Equivalence is a recognition from the EU that the non-EU country’s financial regulations and supervision are of the same standard as those of the EU. Given that the UK, as a member state of the EU, already has such standards in place, granting equivalence status to the UK post-Brexit would be a logical step. However, politics and logic make strange bedfellows. UK financial services entities will be watching this area closely in 2018.

Read our annual outlook report, where we set out our summary of the progress of some important areas of financial regulation in 2017 and look ahead to expected developments in 2018.

STRUCTURED PRODUCTS 2017
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.

$50.2 BILLION

Total notional amount of structured product issuances in 2017.[1] $38.7 billion was issued in 2016.

13,490

Total number of structured product issuances in 2017. 9,362 structured products were issued in 2016.

$3.7 MILLION

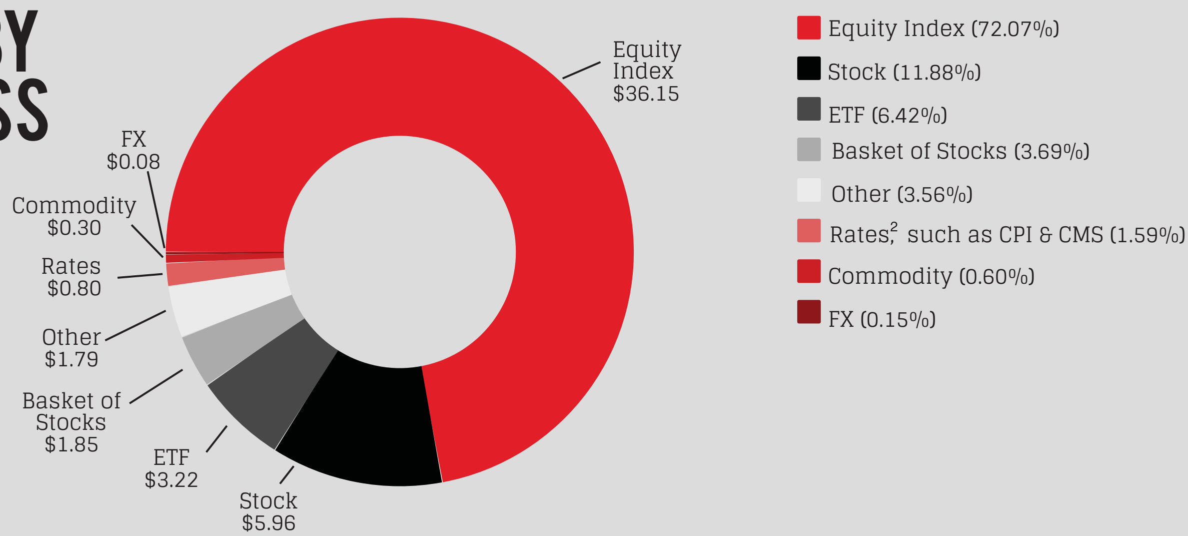
Average size of structured product transactions in 2017. The average in 2016 was $4.1 million.

PRINCIPAL PROTECTED NOTES WITH UPSIDE PARTICIPATION[2]

2017	$357 million	159 Deals
2016	$737 million	271 Deals
2015	$316 million	116 Deals

ISSUANCE BY ASSET CLASS IN 2017

(in $ billions)



MORRISON | FOERSTER

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 2017. 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.

Data source: Prospect News

Upcoming Events

Tax Reform Webinar Series

Wednesday, February 7, 14, and 21, 2018

Wolters Kluwer Webinar, 1:00 p.m. – 2:00 p.m. EST

The Tax Cuts and Jobs Act of 2017 (H.R.1), signed into law by President Trump on December 22, 2017, is the most sweeping change to the U.S. tax code in decades. This historic bill impacts every taxpayer, and calls for lowering the individual and corporate tax rates, repealing the ACA's shared responsibility requirement, enhancing the child tax credit, and more.

Wolters Kluwer and Morrison & Foerster will host a complimentary three-part webinar series focusing on three of the most impactful areas within the tax overhaul:

Session 1: Tax Changes Affecting Holders of Pass-Through Vehicles
Wednesday, February 7, 2018; 1:00 p.m. – 2:00 p.m. EST

Session 2: Corporate Taxation — Domestic Tax Law Changes
Wednesday, February 14, 2018; 1:00 p.m. – 2:00 p.m. EST

Session 3: Corporate Taxation — International Tax Changes
Wednesday, February 21, 2018; 1:00 p.m. – 2:00 p.m. EST

Speakers:
Thomas A. Humphreys, Senior Counsel; and Remmelt A. Reigersman, Partner, Morrison & Foerster

Wolters Kluwer will provide CLE credit.

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

Derivatives Update: Recent Developments in the US and EU

Wednesday, February 28, 2018
IFLR Webinar, 11:00 a.m. – 12:30 p.m. EST

In this session, we will provide an update on recent developments affecting derivatives in the US and EU and prospects for regulatory harmonization between the two jurisdictions. Topics covered include:

With respect to the EU:

- aspects of MiFID II relating to derivatives, including requirements in relation to trading, margin, transaction reporting and position limits; and
- current proposals regarding the supervision of central counterparties and potential amendments to EMIR.

With respect to the US:

- the recent Treasury reports and suggestions for cross-border matters; and
- the CFTC's order exempting EU trading facilities from the requirement to register with the CFTC, comparability determination with respect to the EU margin rules and extension of existing relief in relation to swaps data reporting.

Speakers:
Julian E. Hammar, Of Counsel; Jeremy C. Jennings-Mares, Partner; and James Schwartz, Of Counsel, Morrison & Foerster

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 Structured Retail Products and Euromoney Americas Wealth Management 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.

Contacts

Bradley Berman
New York
(212) 336-4177
bberman@mofo.com

Peter J. Green
London
+44 (20) 7920 4013
pgreen@mofo.com

Lloyd S. Harmetz
New York
(212) 468-8061
lharmetz@mofo.com

Jeremy C. Jennings-Mares
London
+44 (20) 7920 4072
jjenningsmares@mofo.com

Anna T. Pinedo
New York
(212) 468-8179
apinedo@mofo.com

Join Our *Structured Thoughts* LinkedIn Group

Morrison & Foerster has created a LinkedIn group for *Structured Thoughts.* The group serves as a central resource for the financial services community. 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, on our Twitter feed: www.twitter.com/Thinkingcapmkts.

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 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.