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Structured Thoughts

News for the financial services community.

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T+2 Settlement and Structured Notes

Introduction

In December 2015, the "T+2 Industry Steering Committee" published its Implementation Playbook. The Playbook is intended to provide, among other things, a timeline and milestones that market participants should consider in order to migrate to a two-day settlement cycle for different securities. The migration is intended to be completed by the end of the third quarter of 2017.

In this article, we discuss a few aspects of T+2 settlements especially relevant to structured notes.

Impact on Initial Issuances

First, the Playbook is principally directed at secondary market trades. (Similarly, SEC Rule 15c6-1 governs sales in the secondary market.) However, for many transactions, a change in the settlement cycle for secondary market trades is likely to trigger a similar change for the initial settlement. This arises from the fact that, even though structured notes are usually designed to be "buy and hold" instruments, it is possible that an investor may seek to sell a structured note on the same date that the investor agreed to purchase it or shortly thereafter. In order to facilitate the closing of the secondary sale, some market participants will conform the time period for the initial settlement to that of the secondary market.

Benefits of T+2 Initial Settlement

Many believe that a T+2 settlement cycle is likely to yield benefits to the investment community, including reduced credit and counterparty risk, operational process improvements, cash deployment efficiencies, increased market liquidity, lower collateral requirements, and enhanced global settlement harmonization (as discussed in the Playbook).

In the area of structured notes, the shorter settlement period may somewhat reduce the disparity between the level of a reference asset on the pricing date and its level on the settlement date. Similarly, the issuer's "initial estimated value" of the notes on the pricing date will possibly align more closely with the value on the settlement date. An issuer that keys its blackout period to settlement dates, as opposed to only the pricing date, will obtain one more day in which notes may be offered.[1]

Many Offerings Currently Close on a T+2 Basis

We note that many structured note offerings currently close on a T+2 basis. (And T+1 is not entirely unheard of either.) Offerings typically close on this schedule when they price towards the end of the month, and the parties wish to complete the settlement by month-end. This often occurs in the case of reverse inquiry transactions that are arranged near month-end, and the timing of the parties' meeting of the minds as to the terms of the notes does not permit the offering to close by month-end if a T+3 schedule is used. Many broadly-marketed "calendar offerings" also close on this schedule as well. Accordingly, a T+2 settlement cycle would not be completely new to the structured note market.

Platforms Structured Without Regard to the T+3 Cycle

Of course, many offerings currently close on a T+5 schedule (or longer settlement cycle), and some broker-dealer manufacturers of structured notes have T+5 as a default schedule for most of their offerings. These market participants may or may not wish to reduce their typical settlement cycle if and when T+2 becomes the law of the land. It is unlikely that they will be required by any new regulations to make such a change.

Impact on Valuation Dates and Observation Dates?

To the extent that the settlement cycle changes, some market participants may seek to shorten other time periods relevant to structured notes. For example, the standard periods between (a) interest observation dates and interest payment dates and (b) final valuation dates and maturity dates may be shortened as well to match the new T+2 cycle. However, issuers, calculation agents and paying agents will need to review carefully their procedures and capabilities before making any changes of this kind.

Towards a Quicker Settlement Cycle

Shortening the settlement cycle by one business day adds a bit of urgency to ensuring that all necessary documents and signatures required for settlement are ready for use. Initial drafts of any relevant forms of notes, officer certificates, legal opinions and closing instructions will need to be accelerated accordingly, and members of the working group will be encouraged, when practicable, to have these pieces in motion before pricing occurs.

In many cases, the final pricing supplement is itself a "closing document." This can occur when the form of pricing supplement is attached to a form of note for the issuance in order to incorporate by reference the economic terms into the note. Alternatively, a program may utilize a "master note" form, which contemplates a single note for an entire MTN series, with each relevant pricing supplement forming a part of that master note. In these cases, a T+2 settlement cycle would mean that the final pricing supplement must be ready for use approximately one-and-a-half business days after the pricing, since the settlement will occur on the morning of the second business day after the pricing.

The change to the settlement cycle may encourage more issuers to utilize the master note format, as there will likely be fewer documents to create and complete during a shorter settlement window. In addition, the master note format does not require an officer's signature on the note itself.

Market participants will need to review carefully their document suite and procedures to ensure that any accelerated closings will be completed smoothly under the new regime.

[1] For a discussion of blackout periods and their impact on structured notes, please see our November 20, 2015 issue, available at: http://www.mofo.com/~/media/Files/Newsletter/2015/11/151120StructuredThoughts.pdf

FINRA Addresses Inaccurate Levels of a Proprietary Index

In November 2015, FINRA fined a member firm after the member firm published inaccurate levels for a proprietary index. In this case,[2] FINRA demonstrated that index levels published by a member firm can be subject to review and enforcement under FINRA's communication rules.

The member firm maintained a variety of indices that related to certain European asset-backed securities. The indices were used by approximately 40 institutional investors in Europe and were not the underlying asset for any structured notes or derivative products. However, for several years, the indices were published with inaccurate coupon return information. The relevant division of the member firm became aware of these errors and the fact that they would need to revise the historic index levels. However, the member firm continued to publish the indices for several months, without disclosing the inaccuracies to subscribers. Later, the member firm restated the index levels, disclosing that it had understated coupon returns on the relevant securities.

The index errors arose following a variety of calculation and process changes made by the member firm.

Violations

On the basis of these facts, FINRA determined that several of its rules were violated.

Just and Equitable Principles of Trade (FINRA Rule 2010). FINRA concluded that the member firm violated this rule in that index subscribers had a reasonable expectation that the member firm would inform them of significant inaccuracies. However, the member firm did not do so and continued to publish the index with inaccurate levels.

Supervision (NASD Rule 3010(a) and FINRA Rule 2010). FINRA concluded that the member firm violated these rules by failing to properly test the index methodology after its calculation changes were made.

Communications with the Public (NASD Rule 2210 and FINRA Rules 2210 and 2010). FINRA concluded that the member firm violated these rules, particularly because the member firm knew it was providing inaccurate information.

Application to Other Indices and Other Materials

The case is relevant to proprietary indices and other statistical information that broker-dealers engaged in the structured products industry provide to their customers. For example, in addition to disseminating the levels of proprietary indices, some broker-dealers make available to customers information about the performance since the pricing date of the underlying asset for an outstanding structured note's reference asset or the performance of particular notes that have matured. This type of information may help an investor evaluate the value of its current holdings or to assess future investment opportunities.

Of course, knowingly providing incorrect information would be highly problematic under any standard. However, the case stands for the principle that, even if incorrect information is unintentionally disseminated, FINRA will scrutinize a member firm's procedures to determine whether they were carefully designed to prevent this from happening. FINRA's communications rules can be applied to these types of documentation, and an appropriate process should be in place to ensure the accuracy of the information that is set forth.

In this case, the index wasn't used as a reference asset for a structured note or similar product. The inclusion of erroneous index data in an FWP or pricing supplement for a structured note would be even more problematic, as it could also be a basis for a claim for damages or rescission under the federal securities laws.

SEC Issues Research Note Relating to August 2015 Equity Market Volatility

In December 2015, the Office of Analytics and Research of the SEC's Division of Trading and Markets issued a research note discussing the extreme volatility that impacted the U.S. equities market, including the shares of many ETFs, on August 24, 2015. For part of that day, many ETFs traded at prices that differed significantly from their net asset values

[2] FINRA Action No. 2014042781801.

and/or the levels of their respective underlying indices. Some ETF investors were left wondering whether they had received fair prices for sales that they had completed. The events caused a number of issuers of structured notes to reevaluate the disclosures and risk factors used in connection with their ETF-linked products.

The staff's full report may be found at the following link: https://www.sec.gov/marketstructure/research/equity_market_volatility.pdf.

The research note states that it could be used to help assess the operation of the stock market under stressed conditions. However, the note does not necessarily intend to specify the causes of the volatility and did not recommend any regulatory or other steps that may be taken in order to address similar events in the future.

The research note discusses the opening process at several U.S. primary exchanges, the triggering of trading pauses under the National Market System Plan to Address Extraordinary Market Volatility, and the effects of market volatility on trading in exchange-traded products such as ETFs.

The paper, written by SEC staff, looked at issues such as the lack of a uniform approach among exchanges to open trading, including after stocks have been temporarily halted, how trading pauses are triggered in volatile conditions, and how exchange-traded products, like ETFs, are affected by volatility.

According to the research note, the SEC's staff continues to examine the trading issues on August 24th.

The OCIE's and FINRA's 2016 Priorities Letters, and Structured Products

In a bit of a change from recent years, FINRA's 2016 priorities letter does not dedicate as much space to structured products. Similarly, the OCIE's letter does not single out this area. That being said, these offerings and products are likely to remain a focus for the regulators in 2016.[3]

For our more detailed blog entries relating to these letters, please click here:

- FINRA Priorities: http://www.mofo.com/~/media/Files/ClientAlert/2016/01/160106FINRAs2016Priorities.pdf
- OCIE: http://www.bdiaregulator.com/2016/01/ocie-publishes-exam-priorities-for-2016/

In particular, these letters contemplate structured products in a number of areas, including the following:

Conflicts of Interest. FINRA indicated that it plans to complete in 2016 the targeted examination that it launched in late 2015 regarding incentive structures and conflicts of interest. For example, to the extent that structured products remain a proprietary product, FINRA will continue to be interested in how these products are offered and sold.

Suitability. FINRA noted that some firms have failed to tailor their systems for determining suitability and concentration to the specifics of their product offerings. FINRA cited structured products as an example. Similarly, the OCIE expressed an interest in the promotion of new and complex products and related sales practice issues, in order to identify potential suitability issues and potential breaches of fiduciary obligations.

Concentration. On a related point, FINRA noted deficiencies is firms' failure to adequately monitor for excess concentration. This included circumstances in which member firms focused on more risky products without properly ensuring suitable recommendations and avoiding excess concentration. FINRA indicated that it will assess whether registered representatives adequately consider factors such as credit risk, duration, and leverage in connection with complex products.

ETFs. ETFs remain a focus of regulatory scrutiny. For example, the OCIE expressed an interest in the adequacy of risk disclosures and suitability determinations, particularly in the case of nice or leveraged/inverse ETFs.

Broker-dealers can operate under the assumption that structured products remain on FINRA's radar screen in 2016.

[3] If you would like to read these letters in full (which we would encourage you to do), the FINRA letter and its press release may be found at: http://www.finra.org/sites/default/files/2016-regulatory-and-examination-priorities-letter.pdf and the OCIE's letter and press release may be found at: http://www.sec.gov/news/pressrelease/2016-4.html.

Announcing our *Structured Thoughts* LinkedIn Group

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

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

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

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. 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, 2014 and 2015 by *Structured Retail Products.com*.

Morrison & Foerster was named Legal Leader, 2013 by *mtn-i* at its Americas Awards. Several of our 2015 transactions were also granted awards of their own as a result of their innovation.

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