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Structured Thoughts

News for the financial services community.

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Brexit and Structured Products: A Framework for Considering Disclosures

The U.K.'s recent referendum to withdraw from the European Union has affected virtually all segments of the financial industry. The structured products area is no exception. Market participants are considering what responses, if any, are appropriate in their structured products offering documents as a result of this development.

In this article, we propose a framework for considering these issues. In particular, these developments impact both the disclosures that individual issuers make about their business and financial results, as well as disclosures specific to any given product and its underlying asset(s).

Issuer-Specific Disclosures

As is the case for any securities offering, the (yet unknown) impact of "Brexit" could have an impact on the issuer's financial results and creditworthiness. Adverse changes in the issuer's financial condition would impact the likelihood of repayment and the value of the product in question. Some issuers may be more affected than others by these developments. For example, one would expect issuers headquartered in Europe to be more likely to be affected than their North American counterparts. In addition, some North American issuers may be more exposed to developments in the European markets than others, whether as a result of where they conduct their operations, their exposures to different borrower credits or industries, the nature of their trading activities, and other similar factors.

A structured product issuer will typically be an issuer (and, often, a frequent issuer) of other securities. Accordingly, it will assess its Exchange Act reports and other disclosures to determine if they adequately discuss the potential impact (or uncertainties) arising from these developments. We anticipate that most issuers will update their incorporated documents, such as Forms 10-K and Forms 10-Q, with any needed changes, as opposed to making changes only to their structured product offering documents. Doing so will help ensure that these new Brexit related disclosures are incorporated by reference consistently across a wide range of offering documents.

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Disclosures Relating to Specific Underlying Assets

The market gyrations following the announcement of the referendum results indicate that the values of a wide variety of investment assets may be affected by Brexit. Of course, the duration of these changes is not known at present and may change in the future. As a result, future levels of the underlying assets for various structured products have become even more unpredictable.

Equity indices tracking U.K. securities and European securities may be the most likely to bear the brunt of any adverse impact from these developments. Similarly, products that are "bullish" on currencies, such as the pound sterling and/or the euro, may also be adversely impacted. (Some analysts predict upswings in commodity prices, such as gold prices; however, experience may tell us to be careful about predicting future prices of any particular commodity. And of course, any initial increases may be followed by subsequent decreases.)

Market participants will want to review their disclosures as to different underlying assets, particularly the applicable risk factors, and the extent to which they reflect the uncertainties. That being said, the SEC rules (and market practice) do not mandate specific risk factor disclosure as to each and every macroeconomic market development, particularly where those developments are widely known, including by retail investors. Much as we lawyers may feel tempted to revise risk factors for any particular news event, some self-restraint may be appropriate.

A Brief Note About Suitability

Of course, a broker-dealer's duties don't end with good disclosures. Financial advisers will want to consider the extent to which recent changes in the financial markets impact what products should be recommended to which investors. In particular, for risk-adverse investors who are less willing to put principal at risk, a variety of products may warrant more careful review before being recommended. Our world has become just a bit more uncertain than it was before the referendum.

The SEC's Negligence Standard: What Is It, and What Does It Mean?

Introduction

Several years ago, the Securities and Exchange Commission's (SEC) Enforcement Division announced its intention to pursue claims against issuers under Section 17(a) of the Securities Act, utilizing the "negligence standard" contemplated by that provision. In claims against issuers, the SEC generally pleads Section 17(a) claims by alleging that the defendant should have known that its statements were false or misleading.[1] In this article, we summarize this standard.

The Statute and Its Interpretation

Section 17(a) provides:

"[I]t shall be unlawful for any person in the offer or sale of any securities (including security-based swaps) or any security-based swap agreement (as defined in section 78c(a)(78) [1] of this title) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Section 17(a) does not explicitly set forth a negligence standard. However, under relevant case law, the provision has been determined to require a defendant to act in the manner that a reasonably prudent person in its position would have acted under the circumstances. In short, a firm would be expected to "exercise . . . reasonable care in obtaining and

[1] *See, e.g.*, *SEC v. Steffelin*, No. 11-cv-4204 (S.D.N.Y.) (Doc. No. 1).

communicating information," including undertaking "an appropriate investigation before . . . making statements to investors or prospective investors." *SEC v. Shanahan*, 646 F.3d 536, 545-46 (8th Cir. 2011).

Application

How has this standard been interpreted by courts? In the trial of a Section 17(a) claim against a trader in the case of *SEC v. Stoker*, Judge Rakoff of the Southern District of New York instructed the jury that, in considering whether the defendant acted negligently, the jury could consider "any evidence of industry practice, custom, or standards as they pertained to a reasonably prudent person in Mr. Stoker's position at the time [the applicable security] was being marketed." However, the instructions noted that "while such industry practices and the like are relevant, they are not controlling." Instructions of Law to the Jury at 13, *SEC v. Stoker*, No. 1:11-cv-7388 (S.D.N.Y. July 31, 2012), ECF No. 89.

Similarly, in *SEC v. Shanahan*, the Eighth Circuit affirmed a decision to grant defendant judgment as a matter of law following trial on Section 17(a) claims. Here, the SEC "presented no evidence, through expert or lay testimony, documentary evidence or otherwise with respect to the degree of care that an ordinarily careful person would use under the same or similar circumstances, whether [the defendant] exercised reasonable care in obtaining and communicating information, or whether he undertook an appropriate investigation before allegedly making statements to investors or prospective investors." In particular, the court noted that "the SEC offered absolutely no evidence regarding [the defendant's] duties as a member of [the company's] Board of Directors and as a member of the Compensation Committee." *Shanahan*, 646 F.3d at 545-46.

Additional Considerations Relating to Section 17(a)

No Private Right of Action. Only the SEC may bring a claim under Section 17(a). In this regard, the provision differs from Section 10(b) of the Exchange Act and Section 11 of the Securities Act, each of which provide a private right of action to purchasers of the relevant securities.

Offer or Sale Requirement. Unlike Section 10(b) of the Exchange Act, which applies to securities transactions more generally, Section 17(a) only applies to the offer or sale of securities. In other words, the SEC may only bring a Section 17(a) claim based on misstatements made in connection with an offer or sale. In contrast, if an executive of a public company makes a misstatement about the company and an investor reasonably relies on that statement in a transaction on the secondary market, the investor may bring a claim against the executive under Section 10(b), even though the company was not a party to the transaction.

Potential Defendants. Section 17(a) arguably applies to a broader class of defendants than does Section 10(b). Under the Supreme Court's *Janus* decision, only the "maker" of the statement—the "person with ultimate authority over the statement"—is liable for a misstatement under Section 10(b). *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011). And, under *Janus*, ''[o]ne who prepares or publishes a statement on behalf of another is not its maker," and is not liable under Section 10(b). *Id.* However, most courts have held that Janus does not apply to Section 17 claims. *See, e.g.*, *SEC v. Daifotis*, No. C11-137, 2011 BL 199412, at *5-6 (N.D. Cal. Aug. 1, 2011).

As a result, a broker-dealer who negligently "uses" an issuer's misstatement to sell a security may be liable under Section 17(a). See *SEC v. Tambone*, 550 F.3d 106, 127-28 (1st Cir. 2008) ("The statute prohibits an individual from 'obtain[ing] money or property by means of any untrue statement.' It does not state, however, that the seller must himself make that untrue statement. Indeed, the text suggests that the opposite is true—that it is irrelevant for purposes of liability whether the seller uses his own false statement or one made by another individual. Liability attaches so long as the statement is used 'to obtain money or property,' regardless of its source.").

Structured Products and the New Department of Labor Rules: A Checklist for Structured Product Manufacturers and Distributors

In a recent *Structured Thoughts* issue,[2] we discussed the potential impact of the Department of Labor's new fiduciary rules on the structured products industry. In connection with these developments, we have prepared the following checklist that should be considered when potential offerees of structured products include retirement accounts. These issues will be relevant to a variety of entities in the distribution chain: the investment banks that design and manufacture the product and determine the channels into which the products will be sold, as well as the downstream distributors that may face retirement accounts directly.

These issues will often be useful touchstones for determining whether and how a broker-dealer can receive transaction-based compensation (a commission) in connection with a sale under the three principal exceptions: the seller's exception, the Best Interest Contract (BIC) exemption and the Principal exemption.

What Is the "Wrapper" for the Product?

- For example, is the product an SEC-registered note or an exempt bank note? A Rule 144A note? A market-linked CD?
- Recommendations related to a market-linked CD may be eligible for the "principal exemption."[3] Other structured products that qualify for this exemption are limited to debt securities issued by a U.S. corporation and offered pursuant to a registration statement under the Securities Act.
- If the product is a "debt security" (not a market-linked CD), does the product have no greater than "moderate credit risk"? Is it "sufficiently liquid" that it could be sold at or "near" its "carrying value" within a "reasonable period of time"?
- A Rule 144A note will be sold only to QIBs, increasing the likelihood that the sale can be fit into the "seller's exception."

Who Is the Issuer of the Product?

- Is the issuer affiliated with the broker-dealer that is making offers to retirement accounts?
- The BIC exemption and the principal exemption will not be available where the broker-dealer is affiliated with the issuer.

What Are the Planned Distribution Channels for the Product?

- To what extent are "retirement investors" among the offerees?
- Will retail clients purchase through a private bank? Will the product be sold through a private wealth channel?
- Will other broker-dealers purchase the product? Wholesalers? Registered investment advisers?
- Sales to some parties, such as other dealers and larger, professionally managed retirement plans, are likely to qualify for the "seller's exception." However, the fact that some dealer at the end of the distribution chain may face retirement accounts may limit the marketability of some structured products, unless that dealer at the end of the chain has available an exemption.
- The BIC exemption is available only to advisers and financial institutions, and their affiliates and related entities, selling on an agency basis to plans and IRAs that do not meet the requirements for the seller's exception.

[2] The issue may be found at the following link: http://www.mofo.com/~/media/Files/Newsletter/2016/05/160504StructuredThoughts.pdf.
[3] The principal transaction exemption cannot be used if the note is issued by the seller or the note is sold in an underwriting and the seller is a member of the selling syndicate.

What Is the Nature of the "Plan of Distribution" of the Product?

- Will the broker-dealer selling the product be acting as principal (i.e., on a firm commitment basis)?
- Will it be acting as agent (i.e., does it act as an agent to facilitate the sale without committing to purchase any securities)?
- Is the broker-dealer part of an underwriting syndicate for the product?
- What products are recommended by the broker-dealer? Is the universe of recommended products somehow limited to these products?
- The BIC exemption would not be available if the broker-dealer is acting as principal.

What Fees or Other Benefits to the Broker-Dealer Are Associated with the Product?

- Proposed fees can include underwriting compensation, "trailing fees," index licensing fees, hedging fees and others.
- How is the "reasonableness" of the fees determined?[4]
- Does the broker-dealer obtain the benefit of any exclusivity, "shelf space" or similar arrangements as to the product?
- Does the broker-dealer limit its recommendations to proprietary products or products generating third-party payments?
- Do financial advisers receive any special compensation as a result of recommending or selling these products?
- Is the broker-dealer or its affiliate participating in the issuer's hedging transactions?
- Are there any material conflicts of interest?
- If the broker-dealer is to receive transaction-based compensation, an offering to retirement accounts will require an exemption or an exception.
- All third-party payments and material conflicts of interest will be required to be disclosed to the investors.

What Other Roles Does the Broker-Dealer or Its Affiliates Play in the Offering?

- An affiliate of the broker-dealer may, for example, propose to serve as a calculation agent for the structured product's payments or for an underlying asset.
- Who is responsible for choosing the underlying reference asset?
- Who is responsible for sponsoring the underlying ETF?
- Who is responsible for sponsoring the underlying index?
- Is the product structure "proprietary" to the broker-dealer? Does the product feature any special service mark or trade name or other marketing identifiers that are owned or used exclusively by the broker-dealer?
- Even if the distributor is acting only as an agent, is the distributor responsible for distributing all or substantially all of the offered structured products?

Best Interest Standards

- How does the product compare with other available products offering similar benefits in terms of (i) fees and costs, (ii) liquidity and (iii) risk?
- If the product has higher fees/costs, can such higher fees/costs be justified as consistent with the best interests of the retirement investor?

[4] Compensation must be reasonable under the "impartial conduct standards" applying to the BIC exemption, and under the principal exemption, the broker must seek to obtain the best execution available and comply with FINRA's fair price and commission rules.

- If the product involves more than a moderate degree of risk and/or is not fully liquid, can such features be justified as consistent with the investor's best interests based upon potential benefits of the product?
- Is the aggregate compensation received directly or indirectly by the broker-dealer reasonable in light of the services performed?

Compliance Procedures

- What guidelines are in place to ensure that financial advisors will only recommend the product if it is in the investor's best interests?
- What product-specific training will be required?
- How will the best-interest determination be documented?
- How will this documentation be retained?
- Who will be responsible for documentation and retention?
- Are compensation arrangements for registered representatives appropriate and structured so as not to incentivize imprudent recommendations?

Time Period Extended for Consideration of Amendments to FINRA Communications Rules

In our June 6, 2016, client alert,[5] we discussed FINRA's recently proposed amendments to its communications rules, including:

- FINRA Rule 2210 (Communications with the Public);
- FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools); and
- the content and disclosure requirements in FINRA Rule 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings).

In a submission to the SEC dated July 19, 2016,[6] FINRA extended the period for SEC action on the proposal to September 13, 2016, thereby providing the SEC with additional time to consider the proposals. However, the terms of the proposed amendments remain the same.

Upcoming Events

Update on Regulatory and Legal Issues Affecting European Structured Products Issuances
Morrison & Foerster Seminar

Thursday, August 18, 2016
8:30 a.m. – 9:30 a.m. EDT

Morrison & Foerster LLP
250 West 55th Street
New York, NY 10019

[5] http://www.mofo.com/~/media/Files/ClientAlert/2016/06/160606FINRACommunicationsRules.pdf.
[6] http://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2016-018-extension-1.pdf.

This presentation will give an update of legal and regulatory issues that are currently of particular significance in relation to structured products issuances in Europe including:

- Impact of Brexit on structured products issuances in the UK/EU;
- Update on the PRIIPs Regulation and the new KID requirement due to come into effect from the beginning of 2017;
- The new EU Benchmark Regulation due to come into effect from the beginning of 2018;
- Update on MiFID II which is now due to come into effect from the beginning of 2018; and
- Impact of Capital Markets Union and proposed new Prospectus Regulation.

Speaker:

- Peter J. Green
  Partner, Morrison & Foerster LLP

To register or for more information, click here.

CLE credit is pending for New York and California.

Structured Products Washington Conference 2016
Morrison & Foerster Sponsorship
Wednesday, November 9, 2016

The Washington Court Hotel
525 New Jersey Avenue NW
Washington, DC 20001

The 4th annual Structured Products Washington D.C. conference will be returning to the capital on November 9, with the program showcasing the latest developments in the legal, regulatory and compliance landscape for structured products.

For more information, or to register, visit http://www.structuredproductswashington.com/

Join 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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Morrison & Foerster has been shortlisted for Global Law Firm of the Year and for European Law Firm of the Year – Regulatory by *GlobalCapital* for its 2016 Global Derivatives Awards. Morrison & Foerster was named 2016 Americas Law Firm of the Year for the second year in a row by *GlobalCapital* for its Americas 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, 2012, 2013, 2014 and 2015 by *Structured Retail Products.com*.

About Morrison & Foerster

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