Morrison & Foerster News Bulletin

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Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Structured Notes Offered on an Agency Basis

In our last issue,[1] we discussed the potential impact of the Department of Labor's new rules on sales of structured products. In that article, we discussed some of the reasons why future sales of structured notes to retirement accounts may be preferable to effect on an agency basis, as opposed to on an underwritten basis.

However, due to the predominance of underwritten offerings in the structured products space, we find that not all market participants are familiar with the agented format. Accordingly, in this article, we describe some of the aspects of these types of offerings, and how they vary from current practices.

Underwritten Offerings

Most of today's structured notes are offered on an underwritten basis. Under the underwriter's agreement with the issuer,[2] the underwriter is contractually obligated to purchase the relevant notes from the issuer, for its own account, for resale to investors. The underwriter, in turn, agrees with each investor at the time of purchase to sell the notes from its own account to the investor. Accordingly, the underwritten offering essentially consists of two different purchases and sales: (1) the underwriter purchasing the securities from the issuer and (2) the investor purchasing the securities from the underwriter.[3]

[1] Our last issue may be accessed here: http://www.mofo.com/~/media/Files/Newsletter/2016/05/160504StructuredThoughts.pdf.
[2] The agreement is typically a "program agreement" or similar agreement entered into under a "medium term note program."
[3] Additional purchases and sales may be occurring if, for example, the underwriter is selling the securities to third-party dealers, that are in turn purchasing for (a) further sale to other distributors or (b) the actual investors.

In an underwritten offering, the aggregate principal amount of the transaction (set forth on the cover page of the final prospectus) is usually determined based upon the amount of offers received. Subject to the satisfaction of the relevant conditions in the offering documents, the underwriter must purchase all of the notes covered by the applicable prospectus. If an investor fails to settle the purchase, or cancels its order between the pricing date and the settlement date, the underwriter will still be obligated to purchase the full amount of the notes. Traditionally, because of this risk borne by the underwriter, the underwriting commission may be higher than it would be for an offering in which the underwriter does not have this type of a commitment.

Agented Offerings

In an agented offering, the "underwriter" is acting contractually solely as the agent of the issuer. This type of broker-dealer does not have any obligation to purchase the relevant notes for its own account. The ultimate investors are effectively agreeing with the broker-dealer, acting as agent of the issuer, to purchase the notes from the issuer.

Because the offering is agented, and the broker-dealer does not have an obligation to purchase any securities, the relevant "underwriter" doesn't need to use its regulatory capital for purposes of the offering. However, in terms of its potential liabilities, it is typically viewed as a "statutory underwriter," with potential liability for misstatements or omissions in the prospectus. (Conversely, it would also potentially have a due diligence defense if the accuracy of the prospectus disclosure was challenged.)

Some agented offerings of different types of securities require an escrow agent for the offering proceeds, due to the provisions of Rule 15c2-4 under the Exchange Act. This requirement is not applicable to most agented offerings under MTN programs, which are conducted on a so-called "any or all" basis.

Versatility of Program Agreements

Today, structured notes are typically issued in the U.S. under so-called medium-term programs. Not too many years ago, MTN programs were structured principally as agented offerings; accordingly, many of these arrangements refer to the relevant broker-dealers as "agents" or "selling agents," as opposed to "underwriters." However, over the years, most of these agreements, when used by frequent issuers, have been broadened to contemplate underwritten offerings as well. And, in practice, as noted above, most of the offering activity in fact takes place in underwritten offerings.

Multi-Layered Distributions

As noted above, in many distributions of structured products, the underwriter may be distributing the notes through third-party broker-dealers. These dealers will each typically be party to an "MSDA" (master selected dealer agreement) or similar agreement with the underwriter. (Such dealers may also be "wholesalers," selling to other dealers, lengthening this distribution chain.)

In many cases, it will be one or more of these "dealers," and not the "underwriter," that has the relationship with the relevant ERISA account. In this situation, this dealer would need to make the sale on an agency basis. Depending on the distribution arrangements, the dealer could, for example, act as agent for the underwriter. These arrangements would need to be carefully documented to ensure that the role and responsibilities of each of the parties is properly reflected.

Transitioning from Underwritten Offerings to Agented Offerings

In order to convert offerings from the underwritten format to the agented format, a variety of steps should be taken, for example:

- the issuer and the underwriter should review their program agreement or similar agreement (including the relevant "administrative procedures memorandum," if applicable) to make sure that it provides for such an arrangement;
- the provisions of any relevant MSDAs may need to be revised to ensure that, where appropriate, the dealers are effecting sales on an agency basis;
- the plan of distribution and related disclosures in offering documents may need to be updated to reflect these arrangements; and
- confirmations furnished to investors would need to be revised to remove any references to the broker-dealer acting as principal.

Any practice of underwriters holding the offering securities "in inventory" for potential sale to retirement accounts would likely cease, as those sales could not take place on a principal basis.

What Is a Proprietary Product?

In connection with the Department of Labor's new regulations, a new term has entered our lexicon: "proprietary product." These products are subject to a variety of restrictions and disclosure requirements, which we discussed in our prior issue of this publication.

In the structured products area, market participants are quite accustomed to the word "proprietary" in connection with so-called "proprietary indices." In that context, this term is not a legal term, and is not defined by any statute or regulation. However, typically, it refers to an index developed by a financial institution in order to reflect the results of a particular investment strategy and/or to track specific types of assets.

Under the new Department of Labor regulations, a "proprietary product," refers to a financial product that is *"managed, issued or sponsored"* by the financial institution or one of its affiliates. (The initially proposed rule used a somewhat narrower definition, requiring that a product be "managed" by the financial institution or an affiliate.) Accordingly, we now have a U.S. regulation that creates a new legal term.

The problem: in many cases, there is uncertainty as to how this definition should apply to many or most structured products. The terminology used in the definition is hard to apply to an unsecured debt security, which is the "wrapper" for most structured notes.

"Issued." We're pretty sure we understand what it means for a structured product to be "issued" by a financial institution or an affiliate. So, we'll leave that one alone here.

"Managed." In the case of an unsecured debt security, we would like to think that this term is inapplicable. "Management" sounds like a term from the investment company regime, where a fund manager "manages" the investments held by the entity.

On the other hand, to the extent that an underwriter "manages" the distribution, makes a secondary market and provides pricing information, or determines the payments on the notes in its capacity as a calculation agent, does that render a product "managed" and, therefore, "proprietary"? We'd like to think that the answer is "no," and that is not what the new rules are attempting to reach.

"*Sponsored."* This is another term that seems to emanate from the investment company world, and shouldn't be applicable to structured notes. However, under a very broad use of the term, perhaps "sponsor" is broad enough to pick up creating the terms of an instrument, and marketing it? Again, we'd like to think that this is too broad a reading of the term.

During the next several months, industry participants are expected to seek guidance from the Department of Labor as to many definitional and substantive provisions of the new regulations. Questions will arise from virtually all segments of the securities markets. It is our hope that the issues raised by participants in the structured products market will be better understood as a result of these interactions.

FINRA Proposes Amendments to its New Debt Research Rule

On May 24, 2016, FINRA proposed amendments to its new debt research rule (Rule 2422). The amendments are intended to clarify Rule 2422 in four respects: (1) the consent requirement for institutional debt research reports distributed to non-U.S. investors by non-U.S. affiliates of members; (2) the consent requirement for institutional debt research reports distributed to specified persons for informational purposes unrelated to investing in debt securities; (3) the scope of the institutional exemption when distributing third-party debt research reports to eligible institutional investors; and (4) the disclosure requirements for debt research analysts in public appearances.

Distribution to Non-U.S. Investors by Non-U.S. Affiliates of Members

Rule 2242(j) exempts debt research reports distributed solely to eligible institutional investors from most of the provisions regarding supervision, coverage determinations, budget and compensation determinations, and all of the disclosure requirements applicable to debt research reports distributed to retail investors. Rules 2242(j)(1)(A) and (B) require either negative or affirmative written consent for eligible institutional investors to receive institutional debt research pursuant to the institutional exemption. The proposed amendments clarify the application of Rule 2242(j) to non-U.S. investors that are customers of a member's U.S. affiliate but not customers of the member. Specifically, the requirements of Rules 2242(j)(1)(A) and (B) will not apply to the distribution of an institutional debt research report by a non-U.S. affiliate of a member to a non-U.S. investor, provided that: (1) the non-U.S. investor is not a customer of the member; (2) the non-U.S. investor is a customer of the non-U.S. affiliate of the member; and (3) the non-U.S. affiliate of the member has a reasonable basis to believe that the customer meets the definition of "institutional account" in Rule 4512(c).

Distribution to Persons for Informational Purposes

The proposed amendments permit a member to distribute institutional debt research reports to specified persons for informational purposes unrelated to investing in debt securities, provided that the member does not distribute the reports prior to their publication and the member has disclosed that: (1) the member may provide to institutional investors debt research reports that are not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors; and (2) the debt research reports would be provided only for informational purposes and not for the purpose of making an investment decision related to debt securities. The proposed amendments also provide that if the person receiving institutional debt research does not contact the member to request that such institutional debt research reports not be provided, then the member may reasonably conclude that the person has consented to receiving debt institutional research reports. Institutional debt research may be distributed for informational purposes unrelated to investing in debt securities: (1) regulators for regulatory purposes; (2) academics for academic purposes; (3) issuers for the purpose of enhancing knowledge of their industry and competitors and market and economic factors; and (4) media organizations for news gathering purposes.

Distribution of Third-Party Debt Research Reports to Institutional Investors

The proposed amendments clarify that a member that distributes third-party debt research reports to institutional investors pursuant to the institutional exemption must establish, maintain and enforce written policies and procedures reasonably designed to comply with Rules 2242(g)(1), (g)(2), (g)(4) and (g)(6). The review requirements in Rules 2242(g)(2) and (g)(4) for third-party debt research reports and independent third-party debt research reports, respectively, would apply to reports distributed to retail investors or to institutional investors. Accordingly, third-party debt research reports distributed pursuant to the institutional exemption would be subject to the same review requirements as third-party debt research reports distributed to retail investors. With respect to disclosures, the proposed amendments clarify that third-party debt research reports distributed pursuant to the institutional exemption are not required to carry the specific disclosures applicable to retail debt research.

Public Appearances by Debt Research Analysts

Rule 2242(d) requires disclosures from debt research analysts in public appearances, including debt research analysts that only prepare debt research reports pursuant to the institutional exemption. The proposed amendments clarify that the public appearance disclosure requirements do not apply in such circumstances. The proposed amendments require that the member maintain records sufficient to demonstrate that attendance at the public appearance was limited to institutional investors eligible to receive institutional debt research. The proposed amendments also require that the records be maintained for at least three years from the date of the public appearance. The disclosure requirements of Rule 2242(d) would apply, however, where attendance at the public appearance was not limited to institutional investors eligible to receive institutional debt research reports.

The text of the proposed amendments to Rule 2422 is available at:
http://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2016-017.pdf

"It's Not a Culture War" – Yet?

On May 23, 2016, at FINRA's annual conference in Washington, D.C., Richard Ketchum, FINRA's chairman and CEO, delivered a speech that shed a little light on FINRA's recent sweep letter relating to firm culture (see our recent blog post for more information regarding the sweep letter).

According to Mr. Ketchum, FINRA remains principally in a fact-finding posture at present, and is not yet ready to enact culture-related rules or engage in culture-related disciplinary actions. It remains to be seen, of course, whether such developments may occur in the future.

Mr. Ketchum stated that "While it isn't FINRA's goal to prescribe the culture for the industry or to determine the values a firm and reps should have, we think it's essential that the securities industry embrace a culture that puts investors first." He noted that the "fiduciary evolution" impacts how firms interact with clients, and placed FINRA's interest in firm culture in the context of its recent focus on conflicts of interest and compensation practices.

Mr. Ketchum emphasized the importance of firm culture, stating that "a culture that doesn't value ethical behavior has led to compliance failures for firms and significant harm to investors." In addition, he noted that "[a] culture that consistently places ethical considerations and client interests at the center of business decisions helps protect investors and the integrity of the markets," thereby helping to maintain investor confidence in the markets.

In particular, Mr. Ketchum said FINRA continues to examine:

- how a firm identifies and addresses deviations from its standards of conduct;
- hiring practices that result in some firms having substantial concentrations of representatives with a history of disciplinary problems;
- whether a firm's executive officers lead by example, setting the "tone at the top" and establishing and maintaining a proper culture; and
- compensation arrangements and supervisory structures that may be more likely to lead to a poor culture, with resulting harm to customers.

Notwithstanding the lack of clear guidance regarding what a firm's culture should look like, it is clear that a firm's culture will remain an important part of FINRA's future monitoring of broker-dealers.

FDIC Extends Comment Period for Proposed Deposit Account Recordkeeping Rule

The FDIC has recently extended the comment period for proposed recordkeeping requirements for FDIC-insured institutions with at least 2 million deposit accounts. The FDIC's notice of proposed rulemaking from February 26, 2016 solicited comments from the general public and the industry regarding this proposal. After the 30-day extension, the comment period now will close on June 25, 2016.

In our March 2016 article, we discussed this proposal, which is intended to facilitate quick payment of insured deposits if large insured banks fail: http://www.mofo.com/~/media/Files/Newsletter/2016/03/160331StructuredThoughts.pdf. In addition, the FDIC has made its report on the estimated cost of compliance available, which is intended to aid commenters. The report may be found here.

Where Is the Underwriting Commitment Table?

The SEC's recent concept release relating to Regulation S-K[4] has resulted in, among other things, a renewed focus on how the regulation affects different aspects of offering documents. One question that has arisen from time to time relates to the "Plan of Distribution" section that appears in structured note offerings.

Item 508(e) of Regulation S-K contemplates the inclusion in this section of a table that sets forth the underwriting commitments and discounts for each underwriter participating in an offering. These tables can be particularly long and detailed in the case of broadly distributed offerings of debt or equity securities, where a significant number of underwriters are involved, each taking responsibility for a specific portion of the securities to be offered. These tables may reflect the result of significant negotiation among the relevant underwriters.

In contrast, most structured offerings are distributed in a different manner. Typically, one named underwriter will have the responsibility for distributing the entire offering. That underwriter may be selling the securities to investors that maintain a brokerage account with it, or it may be selling the securities to selling group members who have actual relationships with the relevant investors.

In these cases, the structured note offering documents have typically omitted this table. Instead, textual disclosure is used to explain the fact that the relevant underwriter is receiving the relevant compensation. This disclosure will typically appear on the cover page, in the "Plan of Distribution," or some combination of the two.

Item 502 of Regulation S-K contemplates cover page disclosure of the aggregate underwriting discount and the net proceeds to investors. This underwriting discount may be repeated in the "Plan of Distribution" section. In addition, the "Plan of Distribution" section will also describe the nature of the compensation arrangements between the underwriter and any third-party distributors. This compensation disclosure is contemplated by Regulation S-K for inclusion in the "Plan of Distribution" section; however, some market participants prefer to include it on the cover page as well, in part to make it easier for the distributors to find.

SEC Approves FINRA's Educational Communication Rule

The SEC recently approved FINRA's new Rule 2273 (Educational Communication Related to Recruitment Practices and Account Transfers), which requires delivery of an educational communication prepared by FINRA to customers of a transferring representative. The rule will become effective on November 11, 2016.

On May 16, 2016, FINRA released Regulatory Notice 16-18 (http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-16-18.pdf), which provides an overview of the new Educational Communication Rule and includes the rule text and the form of educational communication required by FINRA.

Our summary of the new rule may be found at: http://www.bdiaregulator.com/2016/05/2643/.

All of Your Favorite Index Definitions in One Easy-to-Reach Location

Generic listing standards, broad-based, narrow-based, competing regulators – what's a draftsperson to do when they want to check whether the latest index is kosher? Now there is a one-stop shop designed just for this purpose. We've added a table of definitions of various broad-based indices to our website at: http://www.mofo.com/~/media/Files/PDFs/160526BroadBasedIndicesComparison.pdf

Use it in good health!

[4] We discussed the concept release, and how it relates to structured notes, in a prior issue of this publication, which may be found at: http://www.mofo.com/~/media/Files/Newsletter/2016/05/160502StructuredThoughts.pdf.

Upcoming Events

Financial Regulatory Briefing
Morrison & Foerster Seminar

Thursday, June 2, 2016

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

Please join Morrison & Foerster attorneys at our Financial Regulatory Briefing in New York City.

Agenda:

- The SEC's Focus on the Use of Derivatives by Funds
  8:30 a.m. to 9:30 a.m.
- Asset Management and Financial Stability
  9:30 a.m. to 10:00 a.m.
- Fed's Long Term Debt, TLAC and Clean Holding Company Requirement and its Effects on Financial Institutions Issuers and the Debt Capital Markets
  10:00 a.m. to 11:00 a.m.
- The Single Counterparty Exposure Reproposal, the Net Stable Funding Rule Proposal, and Incentive Compensation at Covered Financial Institutions
  11:00 a.m. to 12:00 p.m.
- *Lunch*
  12:00 p.m. to 12:15 p.m.
- A FinTech Discussion: An Overview of Legal and Regulatory Issues That Arise when Banks Work with FinTech Companies
  12:15 p.m. to 1:15 p.m.

For more information about this complementary CLE seminar, or to register, please click here.

Ending Too Big to Fail: Bank Resolution Strategies and Counterparty Impacts
IFLR Webinar

Wednesday, June 8, 2016

11:00 a.m. to 12:30 p.m. EDT

As jurisdictions continue to move forward with strategies for resolving large banking organizations, recent turmoil in relation to European bank stocks has raised questions as to how markets will react to the initiatives and perceived differences between them. We will take stock of comparative bank resolution regimes and the stated strategies of the resolution authorities under those regimes. We will also look at "pre-emptive" measures such as structural changes and changes to the terms of bank instruments. From a market point of view, we will also discuss the effect that the above factors, the possibility of bail-in, and the need to raise TLAC/MREL/PLAC, will affect the market for bank capital and debt instruments as well as other banking transactions.

Speakers:

- Doncho Donchev,
  Head of Long- and Medium-Term Funding London, Crédit Agricole Corporate and Investment Bank
- Oliver Ireland, Morrison & Foerster LLP

- Jeremy Jennings-Mares, Morrison & Foerster LLP

For more information about this complementary CLE webinar, or to register, please click here.

Setting the New Benchmark: EU Regulation on Financial Benchmarks
Morrison & Foerster Teleconference

Wednesday, June 15, 2016

12:00 to 1:00 p.m. EDT

The new EU Regulation on indices used as benchmarks in financial instruments and contracts is expected to enter into force very shortly and to apply from early 2018. It will introduce a new regulatory regime for firms that administer, contribute to or use financial benchmarks in the EU. It will also impact non-EU benchmarks which are used in the EU. The definition of "financial benchmark" is very wide and will include some customized proprietary indices.

This presentation will look at the relevant provisions of the regulation and consider its practical implications for benchmark administrators, users and contributors.

Speakers:

- Peter Green, Morrison & Foerster LLP
- Jeremy Jennings-Mares, Morrison & Foerster LLP

For more information about this complementary CLE teleconference, or to register, please click here.

SIFMA Complex Products Forum
Morrison & Foerster Sponsorship

Thursday, June 16, 2016

SIFMA Conference Center
120 Broadway, 2nd Floor
New York, NY 10271

The Complex Products Forum is a collaborative event that brings together regulators, distributors, and manufacturers to discuss the issues, challenges, and opportunities related to the sale of complex products to retail investors.

Partner Anna Pinedo will moderate a panel entitled "Complex Products: Changing Regulatory Focus." This session will emphasize the importance customer suitability, financial advisor and investor education and due diligence play in the sale of complex products to individual investors while addressing how the industry prepares for continued regulation of complex products.

Partner Jay Baris will speak on a panel entitled "Regulatory Enforcement Overview: Complex Products 4.5 Years Later." This session will address regulation, compliance and responsibility of firms creating and distributing complex investment products to suit the financial needs of retail investors.

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 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.

Our gratitude to *Structured Products* magazine for naming us Structured Products Law Firm of the Year, Americas, for the seventh time in 11 years is exceeded only by our appreciation for our clients, whose imagination, energy and efficacy inspires us to do our most innovative work.

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

Morrison & Foerster was named the 2016 Equity Derivatives Law Firm of the Year at the *EQDerivatives* Global Equity & Volatility Derivatives Awards. Morrison & Foerster was also shortlisted for 2016 Americas Law Firm of the Year, US Law Firm of the Year – Transactions, and US Law Firm of the Year – Regulatory by *GlobalCapital* for its Americas Derivatives Awards. In 2015, Morrison & Foerster was named Best Law Firm for Derivatives – US by *GlobalCapital* at its Americas Derivatives Awards.

Morrison & Foerster named Best Law Firm in the Americas, 2012, 2013, 2014 and 2015 by *Structured Retail Products.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, Fortune 100, technology, and life sciences companies. We've been included on *The American Lawyer*'s A-List for 12 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. © 2016 Morrison & Foerster LLP. All rights reserved.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.