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STRUCTURED THOUGHTS

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IN THIS ISSUE

SEC FINES BROKER-DEALER FOR EARLY RESALES OF STRUCTURED NOTES
Page 1

STRUCTURED NOTE PRICING SUPPLEMENTS AND BLOOD LETTERS –WHO IS RESPONSIBLE FOR THE DISCLOSURES?
Page 3

WHEN IS AN INDEX SPONSOR AN INVESTMENT ADVISER?
Page 4

SEC FINES BROKER-DEALER FOR EARLY RESALES OF STRUCTURED NOTES

On June 25, 2018, the SEC announced that a broker-dealer settled charges relating to inappropriate resales of structured notes. The SEC determined that the broker had generated large fees by encouraging retail investors to actively trade these notes, even though they were designed to be held to maturity. In these situations, the broker recommended to retail investors that they sell their outstanding notes, and reinvest them in new notes. This activity generated significant fees for the broker, but reduced the customers' investment returns.

The SEC determined that the broker's representatives did not reasonably investigate or understand the costs of these recommendations. The SEC also determined that the broker's supervisory personnel routinely approved these transactions, even though the broker maintained internal policies that prohibited this form of short-term trading.

The SEC imposed a $4 million penalty on the broker, and required the return of more than $900,000 of profits, plus interest.

The SEC's order (the "Order") may be found at the following link: https://www.sec.gov/litigation/admin/2018/33-10511.pdf

EXPLAINING INVESTOR LOSSES

The Order describes in some detail why these types of transactions would be inherently likely to result in investor losses:

Costs Incurred Upon Initial Purchases of Investment: The structured note investments are priced with embedded costs, including the relevant selling concessions, together with structuring and hedging costs. As offering documents now discuss at some length, these costs result in the estimated value of the structured note being less than its purchase price on the pricing date.

Costs Incurred Upon an Early Redemption: Prior to September 2011, the broker's representatives, upon supervisor approval, could charge a sales commission on early redemptions. Even without such a sales commission, due to "markdowns," the price at which the broker would be willing to repurchase the structured note was typically lower than the estimated value of the note.

This cycle would then repeat itself when the investor used the proceeds from the redemption to purchase new notes. Over time, the investor's ability to benefit from any upside performance of the relevant underlying asset would be substantially diminished. The order provides a number of illustrations of these circumstances.

A FEW OBSERVATIONS

- *Product "Switching" - An Area of SEC Focus for Several Years*. As discussed in the November 20, 2015 issue of this publication,[1] the SEC's Enforcement Division has been focused for some time on switching between products, and the resulting potential costs to investors. In many of the cases described in the Order, the sale/reinvestment transactions involved new notes that were linked to a reference asset that tends to exhibit somewhat similar performance over time; for example, a note linked to the SPX may have been sold back to the broker, with the proceeds used for an offering linked to the DJIA.

- *Dates of Transactions*. The trades in question occurred between 2009 and June 2013. The relative age of these sales reflects the broker's determination to help prevent these types of trades. As readers of this publication know, broker-dealers have generally worked over the past several years to improve their compliance and supervision procedures.

- *Relationship to Disclosure Documents*. The Order points out that the relevant offering documents typically emphasized that these were buy-and-hold investments — accordingly, recommendations to sell these products prior to maturity would be inherently at odds with the offering documents.

- *"Locking in Gains."* Some of the broker's representatives justified these exchanges by claiming that customers were "locking in gains" on their original investments. The rationale behind soliciting customers to redeem early was that customers could capture some or most of their gains to date, rather than risk a decline in the performance of the reference asset. However, the benefit of locking in these gains was illusory. First, the fees from the transactions substantially decreased the investors' gains. In addition, the resale transactions prior to maturity in many cases could have resulted in returns that were significantly lower than those the investor would have received had the investment been held to maturity.

- *Supervision and Approval*. The Order points out that the broker's supervisory personnel and compliance team approved these transactions without having an understanding of the economics of these transactions. The broker maintained a pre-approval policy for early redemptions of structured notes. However, a number of representatives continued to engage in these exchanges without meaningful supervision or guidance. Supervisors and compliance personnel were not provided with specific guidance or training on how to review the early liquidation forms, or how to evaluate whether early liquidations were appropriate. Supervisors and compliance personnel routinely approved liquidation requests, and rarely rejected them.

- *"Bad Apples?"* The Order emphasizes that there were two representatives in particular who conducted these transactions on a regular basis. The Order noted that most representatives of the broker engaged only infrequently in the problematic practices.

continued on page 3

RECOMMENDATIONS

The June 2018 Order is a reminder to broker-dealers to review their existing policies and practices as to the early redemption of structured products. Policies should be clear as to, and representatives should be trained on, the circumstances under which these transactions are appropriate. Appropriate monitoring procedures should be in place to track whether these transactions are occurring and, if so, whether there is a pattern related to particular representatives. Where certain representatives have a track record of effecting these transactions, compliance personnel should review whether they are appropriate.

Structured products are generally considered "buy and hold" transactions. The Order illustrates the issues that can arise when these products are traded in a manner that isn't consistent with their design.

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1 See https://media2.mofo.com/documents/151120structuredthoughts.pdf, page 4.

STRUCTURED NOTE PRICING SUPPLEMENTS AND BLOOD LETTERS – WHO IS RESPONSIBLE FOR THE DISCLOSURES?

Allocation of Liabilities. Issuers and underwriters routinely enter into underwriting agreements and program agreements that purport to place any and all liability for misstatements or omissions on the issuer's shoulders. These provisions are drafted with the U.S. securities laws in mind — in particular, Section 11 and Section 12 of the Securities Act 1933. This allocation is accomplished through a combination of (a) representations from the issuer as to the accuracy of the offering documents and (b) indemnification provisions that require the issuer to cover the underwriter for any liabilities (including legal expenses) arising out of misstatements and omissions.

Exception — Underwriter Information. However, there is one small exception to this general rule — underwriters take liability for the (very limited amount of) information that they provide for inclusion in the prospectus. This category of information is intended to be very narrow in scope, and to cover solely information of which only the underwriter would have precise knowledge about, and that is outside of the issuer's specific knowledge. For example:

- the concessions that the underwriter will pay to selling group members in connection with sales;
- the underwriter's planned price stabilization transactions for the relevant securities, such as short sales and syndicate covering transactions[2]; and
- the specific names of the co-underwriters participating in the offering.[3]

The Paperwork. This exception to the general principles of the underwriting agreement is achieved through carve-outs to the representations and indemnity provisions. In many cases, the underwriters will deliver at closing a "blood letter," in which they take specific responsibility as to these (limited) disclosures. A blood letter can be specifically tailored to the disclosures in the particular offering.

In terms of its phrasing, a typical provision will remove from the issuer's liability, and impose liability on the underwriters for, "information provided in writing by the underwriters specifically for inclusion in the prospectus."

Application to Structured Products. The wording of this type of provision raises an issue in the context of structured note offerings — in these offerings, the underwriter or its counsel may, at least in a literal sense, provide virtually all of the information that appears in the offering document. In some cases, underwriter counsel drafts and provides the entire document. In other cases, they provide key sections, such as the hypothetical returns, and the historical performance of the underlying asset.

Accordingly, it would seem that the term above, "information provided in writing by the underwriters specifically for use in the prospectus" must be viewed as a term of art. Market participants would agree that, in the structured note world, this provision is intended to include only information as to which the underwriters

continued on page 4

specifically indicate that they are accepting liability. Since most structured notes are offered using an existing program agreement, and not an individual underwriting agreement, the information would be identified in a "terms agreement" for the offering that is executed on the pricing date, or potentially, a separate blood letter. In the absence of such a provision, it would appear that the parties intend for all of the key disclosures about the product to remain the issuer's responsibility, in accordance with customary practice.

2 These items are more typically associated with larger syndicated offerings, as compared to structured note offerings.

3 This information is usually known precisely only to the lead-underwiter(s), as not all underwriters will sign the underwriting agreement. Per the prior footnote, this point is typically not relevant to structured note offerings.

WHEN IS AN INDEX SPONSOR AN INVESTMENT ADVISER?

In March 2018, Dahlia Blass, the Director of the SEC's Division of Investment Management, delivered the keynote speech to the Investment Company Institute's 2018 Mutual Funds and Investment Management Conference. A copy of her remarks may be found at the following link: https://www.sec.gov/news/speech/speech-blass-2018-03-19.

Among other topics, Director Blass addressed a topic that has attracted the interest of many participants in the structured products market over the years – under what circumstances can an index sponsor be considered an investment adviser, thereby requiring registration under the Investment Advisers Act?

EVOLUTION OF REGISTERED INDEX FUNDS (I.E., INDEX FUNDS REGISTERED UNDER THE INVESTMENT COMPANY ACT)

Director Blass pointed out that, in the registered index fund industry's initial phases, most funds linked to indices that were broad and widely understood. In contrast, many indices today focus on narrow strategies. These include "smart beta" funds, which provide a customized weighting to an index. And of course, many funds today track custom or proprietary indices.

In light of these developments, Director Blass encouraged the consideration of whether certain index providers should be considered investment advisers.

AN UNSETTLED QUESTION

Director Blass noted that under the Investment Advisers Act, index providers have historically concluded that, even if they are investment advisers, they may rely on the "publisher's exclusion" from the definition of "investment adviser." However, Director Blass indicated, recent developments appear to have moved certain index providers away from what we might think of as "publishers."

While not purporting to resolve the question as to all index providers, Director Blass offered a number of considerations that may be relevant in making this determination:

- What if the index in question is maintained solely for the benefit of one single fund?
- What if the index provider receives input from the fund's sponsor or board regarding the creation, composition or rebalancing of that index?
- What if the index provider and the fund sponsor are related entities?

In each of these cases, there may be a nexus between the index provider and the investments made by the fund significant enough to warrant evaluating whether the index provider needs to be registered as an investment adviser. The relevant facts and circumstances may control the outcome.

DISCLOSURE ISSUES

Director Blass also encouraged the audience to consider whether funds that track these types of indices include adequate descriptions of the indices in their prospectuses. Specifically, do fund investors understand the index strategy and how investment decisions are made? While Director Blass raised many interesting points, we wonder whether requiring an index provider to register as an investment adviser is necessary to provide fund investors with information that might be more appropriately delivered through the disclosure documents of either a fund or its adviser. We also

wonder whether requiring index providers to register as investment advisers would result in greater investor protection. Of course, as proprietary indices have become more complex, these disclosure and investor protection issues concern index providers not only with respect to registered funds, but also with respect to products offered only under the 1933 Act, such as exchange-traded notes.

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