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Structured Thoughts

News for the financial services community.

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U.S. Structured Warrant Programs

Introduction

U.S. and non-U.S. banks have offered structured warrants in the U.S. to address the needs of both institutional and high-net worth investors. This article will describe these instruments, how they are offered, and summarize the programs that are used to offer them.

What Are Structured Warrants?

Structured warrants are a form of structured security which are designed to have many of the features of warrants or options over a reference asset. They are typically issued by financial institution issuers, such as bank holding companies. They are purchased with cash, and any required payments to the investor may be made either in cash or "in-kind," such as in shares of the relevant stock covered by the warrant, depending on the terms of the relevant instrument. Sample structured warrant terms are in the box set forth below.

Structured warrants are not standardized options of the type issued by the Options Clearing Corporation. Purchasers of OCC standardized options have the credit benefits of guarantees and margin and collateral deposits by OCC clearing members to protect the OCC from a clearing member's failure. In contrast, investors in structured warrants can look only to the issuer for performance of its obligation to pay the cash or other assets due upon payment.

Structured warrants are typically not listed on any securities exchange. Any secondary market for these instruments is typically much more limited than that of standardized OCC options. As is the case for structured notes, investors can typically only look to the dealer from whom they purchased the instrument for liquidity.

Sample Structured Warrants Linked to Equity Index ABC

Issuer:	XYZ Bank Holding Company
Price per Warrant:	$10
Notional Amount per Warrant:	$1,000
Warrant Premium:	10% [Warrant Premium divided by Notional Amount]
Issue Date:	July 1, 2015
Valuation Date:	[Six months] after the issue date.
Cash Settlement Amount:	The greater of (A) $0 and (B) the notional amount per warrant multiplied by the lesser of (A) the Index's percentage return as of the Valuation Date and (B) the Maximum Return. The return of the Index must be greater than 10% (the Warrant Premium) in order for the investor to receive a positive return on its investment. The warrants will expire worthless and the investor will lose its entire principal amount if the final level of the index is less than its initial index level.
Maximum Return:	[5]%

Key Differences from Structured "Notes"

Structured warrants differ from structured notes in a number of ways. For example, structured warrants are more likely, by their terms, to expire and lose all their value if the relevant underlying asset does not increase or decrease by the required amount. They do not pay any interest prior to maturity. Because of their terms, their trading value may be even more volatile than a "typical" structured note linked to the same underlying reference asset.

Public vs. Private Offerings

Structured warrants may be sold in a "public offering" under a registration statement. Most financial institution issuers of this product class register warrants in connection with their filing of a "universal shelf," so that such registration statement may be used for this purpose.

In addition, structured warrants may be offered exclusively to institutional investors under Rule 144A, or to "accredited investors" under U.S. Regulation D.

Accordingly, the selection of the proper offering platform depends in large measure upon the intended purchasers. When available, using non-registered offerings will avoid the payment of SEC filing fees, help enable the investor to maintain the confidentiality of the offering terms, enable the use of reference assets that may not be permitted under the SEC's "Morgan Stanley" no-action letter, avoid the "qualified independent underwriter" requirement discussed below, and potentially reduce the potential litigation risk of these offerings. Accordingly, a non-registered offering may be a preferred option, particularly when only institutional investors are contemplated. Of course, there are significant restrictions on the

transfer of Rule 144A and Regulation D securities, and many individual investors are more comfortable (and accustomed to) investing in a registered instrument.

FINRA Suitability Rules

Because of their leveraged nature and potential for loss, structured warrants are typically regarded as complex investments. Accordingly, broker-dealers exercise caution in recommending the product to investors and screening the relevant investors for purchase. Structured warrants are typically offered only to options-eligible investors. Significant minimum purchase amounts are also often imposed in order to help reduce the likelihood that they will be purchased by less sophisticated investors.

Structured warrants are typically viewed as significantly different from structured notes. Accordingly, broker-dealers typically subject them to a new product approval process and where needed, offer new training and education to their representatives prior to permitting them to offer these investments to accounts.

Qualified Independent Underwriters

In public offerings of warrants, FINRA's "corporate financing rule" applies. This rule requires the underwriting arrangements and underwriting compensation to be reviewed by FINRA in the absence of an exemption. Structured notes and other debt securities issued by financial institutions typically qualify for the exemption provided for investment grade debt securities. However, to the extent that structured warrants are not "debt securities," they do not qualify for this exemption.

Accordingly, to offer structured warrants in a registered offering, the issuer typically will involve in the offering a "qualified independent underwriter" ("QIU"), as required by FINRA Rule 5121. Among other requirements, A QIU must, for example, participate in the preparation of the registration statement and prospectus, and exercise the usual standards of due diligence in respect of the offering documents.

SEC-Mandated Estimated Value Disclosures

In the case of registered offerings of structured warrants, the SEC's required "issuer estimated value" (and related risk factors) is typically included, as is the case for structured notes. Practices vary in the case of non-registered offerings, depending upon, for example, the nature of the intended purchasers.

Structured Warrant Programs—Principal Documentation

Offering Documents

As noted above, structured warrants may be publicly offered under a registration statement. Accordingly, in addition to the registration statement's base prospectus, the issuer will typically create a "prospectus supplement" that describes in more detail the types of warrants that are expected to be issued. Each individual offering is then documented by a shorter "pricing supplement" that describes the specific warrants being offered and a description of the relevant risk factors and underlying asset.

In the case of a private offering, a standalone offering circular may be created that describes the terms of the program and that incorporates by reference the issuer's financial statements and other material information from its periodic filings. This document would in turn be supplemented in each offering by a pricing supplement.

Program Agreement and Product Distribution

As is the case for debt securities, a program agreement or similar distribution agreement will be created for structured warrants. This agreement will in many respects resemble the type of agreement used for the relevant issuer's debt securities, with appropriate terms modified to reflect the nature of the instrument.

For many issuers of structured warrants, the distributors will be one or more of the distributors who also distribute the issuer's debt securities. Accordingly, the program agreement will often provide that some or all of the periodic auditor comfort letters and legal opinions ("negative assurance letters") that are provided as to the debt securities will also be sufficient for the "warrant program." A provision of this kind can reduce the ongoing cost of maintaining a program.

For those underwriters that sell these instruments through unaffiliated broker-dealers, additional documentation may be in order. For example, the existing MSDAs or similar agreements between the underwriter and the third party broker dealers may only cover “notes” or “debt securities,” but not warrants.

Warrant Agreement and Forms of Warrants

The issuer will typically enter into a “warrant agreement” or “warrant indenture” with a third party issuing and paying agent. This agreement is similar in some respects to a “paying agency agreement” used for debt securities, in that it:

- describes the role and responsibilities of the “warrant agent”;
- sets forth the mechanics for payments by the issuer to the warrant agent that will be distributed to warrant holders; and
- contains one or more forms of warrants that will be used.

This agreement may be comparable in many respects to the type of debt indenture that is used in the case of registered debt securities in order to comply with the requirements of the Trust Indenture Act of 1939.

In the case of a registered offering, the form of this agreement and the forms of warrants are typically filed as an exhibit to the registration statement.

Building a Better Survivor’s Option

Introduction

First of all, let’s define a phrase. A “survivor’s option” is a provision, often included in a structured CD or a structured note, that enables the heirs of a deceased holder to redeem the instrument at its par value upon the holder’s death. A provision of this kind may also be triggered upon the determination that the holder is “incompetent.”

Of course, market participants use a variety of different names for this type of provision, including “estate feature.” Some, perhaps those with a more gothic sense of style, use the term “death put.” This article will use these terms interchangeably. (On second thought, this article might not use the term “death put” again after this paragraph.)

The Survivor’s Option and Controversy

These provisions are designed for the benefit of investors, but they are not without controversy. It has been reported that some financial advisers have attempted to profit from the difference between the trading price of a note or a CD and its par value by purchasing the instrument for less than par, and holding it in an account of a person with a short remaining life expectancy. If this practice occurs in significant amounts, an issuer can find itself redeeming a significantly higher amount of CDs than anticipated at the time of issuance. A solution or two to that problem is discussed below.

Do I Need a Survivor’s Option?

The answer is “maybe.” On the one hand, there is no securities law or banking law requirement to have one. However, many distributors of structured products prefer to offer products with these terms to their customers, especially when offering to senior investors. And many individual investors have come to expect the term in the instruments they buy.

Of course, for the avoidance of doubt, if the offering is being made solely to institutional investors for their own accounts, this term is not necessary.

The survivor’s option may make the product more attractive to investors. However, some issuers prefer to avoid including it. Treasury departments prefer the certainty of knowing exactly how long an instrument will be outstanding, and of course do not like to redeem notes or CDs when their cost of funding has risen. Moreover, administering requests for redemption under a survivor’s option involves time, cost and occasional frustration.

Holding Period

Some survivor’s options may only be exercised after the holder in question has held the instrument for a specified period, such as six months. This term is designed in part to thwart the plans of those who, as set forth above, would attempt to

sneakily transfer the instruments to the weak or frail in the hopes of turning a profit. In a more restrictive version of this provision, the right may only be exercised by the initial purchaser of the instrument, and not by any transferee in the secondary market.

When Will Payments on the Option Be Made?

A survivor's option may be designed for the maximum convenience of the investor's heirs: payment will be made at any time, upon proper exercise. Alternatively, payments may be scheduled for the convenience of the issuer: fixed quarterly or semi-annual dates, or on dates that coincide with interest payments. The "issuer-friendly approach" helps the issuer and any paying agent aggregate any required payments, and may facilitate record keeping.

Payment Limitations

What some issuers give with the left hand, they take away (in part) with the right hand. In order to limit the impact of survivor's option provisions, the terms of the instrument may limit the investor's rights to payment. For example:

- Each note or CD (according to CUSIP) may be subject to a maximum notional amount that may be redeemed.
- An issuer may subject its entire note or CD program to a maximum notional amount that may be redeemed.

These types of limits may operate on an annual basis, or for the life of the instrument. If the limit operates on an annual basis, redemption requests that exceed the annual limit may be "rolled" into the next calendar year, when the limit "resets."

Timing Limitations

A survivor's option may be structured so that it must be exercised within a specified amount of time after the relevant death or incompetence. A fixed period, such as one year, is arguably sufficient for the heirs of the holder to sort out the deceased's assets. Imposing such a time limitation is also designed to prevent the option from being exercised solely due to decreases in the value of the instrument and/or its underlying asset in the period following the death or incompetence.

"Who's Death Is It, Anyway?"

If an instrument is held by a single individual, it's easy to determine whose death or incompetence triggers the survivor's option. The situation can be a bit more complicated when there are multiple beneficial owners such as:

- spouses or domestic partners;
- family members holding jointly; or
- trustees and beneficiaries.

A well-drafted survivor's option provision will make it clear whether one, more than one, or all holders of an interest must pass away or become incompetent for the right to be triggered.

A Practice Tip

Different market participants may have different views as to how a survivor's option should operate, and any limits that should be placed on that option. However, once a note or CD is outstanding, actual redemptions will require an exchange of paperwork, and ultimately, a transfer of funds, between the issuer, the relevant broker and/or the paying agent/trustee for the relevant program. Accordingly, before finalizing any provisions in an offering document, issuers and underwriters are encouraged to make sure that these provisions reflect the actual processes and capabilities of the relevant parties. Once the offering "goes live" and the instrument is issued, the survivor's option provision will exist for the entire term of the instrument.

Issuers will also prefer to have one standardized form of the survivor's option provisions. Doing so will reduce the time needed to determine the validity of a proposed exercise, and the required paperwork for doing so. Of course, as time passes, and as investor preferences change, the provision used may change.

SEC Announces a Settlement with a Structured Products Issuer

On October 13, 2015, the SEC announced a settlement with an issuer related to alleged material misstatements and omissions in the issuer's offering documents for certain registered structured notes.[1] The structured notes were sold to "retail investors" (it is not clear from the publicly available information whether these were high net worth investors) and linked to a proprietary index that tracked G10 currency foreign exchange forward rates.

According to the settlement documents, the index was described as being a “transparent” and “systematic” trading strategy, and the index was calculated using “market prices.” The SEC’s order focused on undisclosed hedging activities by the issuer that negatively affected, or had the potential to affect negatively, the level of the index. The order alleges that the hedging activities distorted the pricing inputs used by the index.[2] These activities allegedly included the addition of markups to hedging transactions, which led to index pricing inputs that were inconsistent with market prices, and the addition of spreads to internal hedging trades, the prices of which (including the added spreads) were used to calculate the index.

In various issuer free writing prospectuses filed with the SEC, the issuer reported on the performance of the index, attributing changes in the index level to macroeconomic events. Those free writing prospectuses did not disclose the issuer’s hedging activities, some of which appear to have contributed to a drop in the index level.

The order focused on the issuer’s lack of an effective policy, procedure or process by which individuals within the issuer with primary responsibility for drafting disclosure documents relating to the index and the structured notes linked to the index would be aware of the activities of other employees that had, or potentially could have had, a negative effect on the index level. According to the SEC, because the individuals drafting the disclosure documents had no way to make informed decisions about the index disclosure, the issuer negligently breached its duty to disclose all material information necessary to make the statements in the offering documents, in light of the circumstances under which they were made, not misleading.

Due to the allegedly negligent conduct and the materially misleading statements and omissions, the SEC claimed that the issuer violated Section 17(a)(2) of the Securities Act. Without admitting or denying the SEC’s findings, the issuer agreed to cease and desist from committing or causing any violations or future violations of Section 17(a)(2), and to pay disgorgement and prejudgment interest. The SEC noted the issuer’s cooperation in investigating this incident and the issuer’s centralization and improvement of its internal controls.

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[1] The SEC’s Cease and Desist Order (the “Order”) can be found at: http://www.sec.gov/litigation/admin/2015/33-9961.pdf.

[2] The SEC noted in paragraph 11 of the Order that the issuer’s addition of spreads to hedging transactions was not “adequately disclosed.”

Prospectuses for structured products normally include risk factors related to hedging and other risks. The offering documents for these products included the following risk factors related to hedging, the effect of issuer transactions in instruments related to the underlying currencies and the determination of prices used by the index:

> “**Trading and other transactions by the Issuer or its affiliates in the foreign exchange and currency derivative market may impair the value of the Securities** — We or one or more of our affiliates may hedge our foreign currency exposure from the Securities by entering into foreign exchange and currency derivative transactions, such as options or futures on exchange-traded funds. Our trading and hedging activities may affect the Index and make it less likely that you will receive a return on your investment in the Securities. It is possible that we or our affiliates could receive substantial returns from these hedging activities while the market value of the Securities declines.
>
> …
>
> These transactions and activities are not entered into for the account of holders of Securities or on their behalf and may present a conflict between your interest in the Securities and the interests of the Issuer and its affiliates, in their proprietary accounts, in facilitating transactions, including options and other derivatives transactions for their customers and in accounts under their management.
>
> …
>
> **The Issuer will determine the market price of the foreign exchange forward contracts underlying the Index** — The foreign exchange forward contracts underlying the Index are foreign exchange forward contracts with terms of up to six months traded in the over-the-counter market. The prices of such contracts used to calculate gains and losses from notional settlement of hypothetical positions will be based on the market prices at 4:00 p.m. Zurich time (or shortly thereafter taking into consideration available prices for the number of foreign exchange forward contracts that would need to be hypothetically settled as a result of such determination), on the applicable valuation date….”

Conclusion

The SEC continues its focus on structured products with this action, the first, according to the SEC, against an issuer of structured notes. The SEC is focused on sales of structured products to "retail investors" and also with respect to the accuracy of disclosures.

Besides ensuring that an issuer has processes in place to inform investors of all activities by its employees that may have an effect on the materiality of its disclosures, an issuer should also check its risk factors and descriptions of hedging and other activities to determine if they are broad enough to disclose all material transactions.

Reminders for Index Linked Notes

In light of the settlement, other regulatory guidance and "best practices," market participants should consider (and often *reconsider* for improvement) a variety of issues when linking notes to complex underliers, including many proprietary indices. Understanding these factors will help the working group consider what disclosures and/or risk factors are appropriate.

- Index Disclosures
    - *Ownership:* is the index owned, sponsored or calculated by the issuer or an affiliate?
    - *Rules:* have index governance rules, and/or a process for index governance, been put in place? When and why, if applicable, are any index rules changed or superseded?
    - *Transparency:* are the index descriptions and index methodologies transparent?
    - *Fees and Costs:* are there any fees, charges or other factors that could reduce the level of the index at any time? How are they calculated, and who does the calculating?
    - *Third Party Providers:* are they regulated by any governmental agency? Do they comply with the index standards articulated by IOSCO and ESMA? What types of compliance policies and procedures do these entities maintain?
- Hedging Activities
    - What types of hedging activities will be conducted? Who is responsible for supervising them? Are any unusual hedging activities going to be conducted?
    - Do the offering documents adequately disclose any known (and especially, unusual) hedging activities?
    - Are there any spreads built into the hedging activities that could affect the level of the index and/or the payments on the notes?

FINRA Advertising System Expands Submission Formats

Effective September 28, 2015, FINRA migrated its Advertising Regulation Electronic Files ("AREF") system to a new electronic platform. The new platform allows broker-dealers to submit their advertising-related files through an increased number of electronic formats and to submit larger files.

The change reflects the increasing creativity of broker-dealers in developing audio and video materials that are within the rubric of FINRA's advertising rules. As these materials have become more complex, with greater reliance on graphics, FINRA has needed to expand the system's capability to accept these types of filings. As readers of this publication know, the structured products industry has made significant efforts to create documents that help illustrate to investors the terms and risks of these products, and have been doing so in a variety of different formats.

In the new system, permitted audio and video format include MP4, WMV and WAV, as well as files in "Excel" and "PowerPoint." The new system increases the file size limit from 50MB to 500MB.

Use of the electronic system remains voluntary.

FINRA maintains a variety of materials relating to the system, including a navigation guide and training materials, at the following website: http://www.finra.org/industry/regulatory-filings/advertising-regulation-electronic-files?utm_source=MM&utm_medium=email&utm_campaign=Weekly%5FUpdate%5F100715%5FFINAL.

For a discussion of how FINRA's advertising rules impact offerings of structured notes, including the related filing requirements, please see our articles at the following links:

- http://www.mofo.com/special-content/structured-products/mofostructuredthoughts; and
- http://media.mofo.com/files/Uploads/Images/120119-Structured-Thoughts.pdf.

Structured Products Washington Conference 2015:
Regulatory, Legal and Compliance Issues Impacting Structured Products

Please join Morrison & Foerster at the Structured Products Washington Conference 2015. This fall, regulators, in-house counsels and legal advisers in the derivatives and structured products business will gather for a day of essential discussions on regulatory changes in the market and rewarding networking with industry peers in the region.

The event will take place on **November 5, 2015** at the Fairfax at Embassy Row, 2100 Massachusetts Avenue, NW, Washington, DC 20008.

Topics Will Include:

- Disclosures, pricing, new products and emerging issues;
- The SEC update on new and exchange traded products;
- Marketing derivatives and structured products;
- Index governance and maintenance;
- Bank regulatory issues affecting structured notes issuers;
- Enforcement issues relating to structured products;
- Tax developments;
- Investment Company Act and Advisers Act issues;
- Suitability, KYD and other compliance issues, and
- Preparing for a FINRA or OCIE exam compliance basics.

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

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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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