Structured Thoughts

News for the financial services community.

SEC Announces Sweep Relating to Structured Products

In April 2012, the SEC's Division of Corporate Finance announced that it had sent a letter to certain financial institutions relating to their structured note offerings. The text of the letter may be found on the SEC website at the following link: http://www.sec.gov/divisions/corpfin/guidance/cfostructurednote0412.htm.

The SEC's letter consists of 14 numbered paragraphs. The letter contains several statements of the Staff's positions relating to structured notes (some of which repeats, or elaborates on, prior guidance), and requests for additional information from issuers (some of which may lead to further issuer-specific comments). As discussed in more detail below, the letter may lead to a variety of changes in current offering practices, as well as additional regulatory actions by the SEC.

Reminders as to Certain Disclosure Practices

Several of the items in the letter have been addressed in prior actions or statements by the SEC:

- A request that issuers evaluate the title of their notes to ensure that they do not use terms such as "principal protected" in a misleading manner.[1] This request relates to all types of notes that an issuer may offer, whether or not they are "principal protected."

- With respect to liquidity, the SEC's letter requests information as to the circumstances under which the issuer or its affiliates repurchase notes from investors prior to maturity, suggesting that issuers provide more information in their offering documents.

- A request that the cover page of each prospectus disclose the fact that an investor faces "issuer credit risk" in a "clear, consistent and prominent manner."

- Echoing its analysis in Staff Legal Bulletin No. 19 (October 2011),[2] the SEC's letter reminds issuers that the tax consequences of most structured products are "material" and requests information as to how issuers comply with the relevant requirement to file a tax opinion.

- The SEC's letter reminds issuers that disclaimers of responsibility for information regarding an underlying asset is inconsistent with the issuer's obligations under the securities laws, and that some disclaimers of this kind may need to be revised.[3]

Disclosure Format

As readers of this article already know, structured note offering documents are typically constructed with a mix of term sheets, prospectus supplements and product supplements, depending on the relevant issuer and the nature of the offering. The potential complexity of this format is an issue that has arisen in a number of different contexts, including the UBS securities litigation relating to Lehman Brothers' structured notes[4] and the SEC's releases relating to asset-backed securities.[5] In addition, different underwriters make different uses of short-form, free-writing prospectuses and statutory prospectuses. The SEC's letter requests additional information from each issuer as to the documents that they create and how information is divided between these documents. This particular question could lead to additional regulatory action from the SEC as to the appropriate format for offering documents.

Potential New Disclosures

The SEC's letter highlights existing issuer disclosure indicating that a portion of an offering's use of proceeds will be used for hedging transactions and suggests that such amounts be quantified. If there are no specific plans for a significant portion of an offering's proceeds, the letter indicates that the issuer should note the reasons for the offering. This focus on hedging activity also relates to the SEC's request for additional disclosure as to the estimated value of structured notes on the pricing date, as discussed below.

The SEC's letter suggests that structured note programs may be relevant for disclosure in an issuer's Exchange Act reports, potentially in the MD&A section. The letter seeks information about how an issuer's structured notes fit into

[1] In 2011, the SEC and FINRA issued a joint alert encouraging investors to pay close attention to securities referred to as "principal protected" and to note the limitations of the principal protection. (http://www.sec.gov/investor/alerts/structurednotes.htm) The alert followed calls from the Staff to certain issuers requesting that they revise their usage of the term "principal protected."
[2] Staff Legal Bulletin No. 19 may be found on the SEC's website at the following page: http://www.sec.gov/interps/legal/cfslb19.htm.
[3] The Staff also addressed "impermissible disclaimers" in free-writing prospectuses in connection with its 2005 Securities Offering Reform. (SEC Release 33-8591; 34-52056; IC-26993; and FR-75 (April 2010).
[4] In re Lehman Bros. Sec. & ERISA Litig., 799 F. Supp.2d 258 (S.D.N.Y. 2011).
[5] SEC Release Nos. 33-9117 and 34-61858; and File No. S7-08-10, page 97, "We are concerned that the base and supplement format has resulted in unwieldy documents with excessive and inapplicable disclosure that is not useful to investors."

its overall financing and liquidity, and trends in their usage. The letter also requests quantitative information as to the outstanding amounts of an issuer's structured notes.

Product Pricing and Value

In July 2011, the SEC's Office of Compliance Inspections and Evaluations ("OCIE") issued a report relating to its findings following its investigations of several broker-dealers.[6] The OCIE report raised questions as to the pricing policies and practices of market participants, and the SEC's letter reflects some of those concerns. In that regard, the SEC letter:

- indicates that market participants should consider prominently disclosing the difference between a structured note's public offering price and the issuer's estimate of its fair value (or discussing with the Staff the reasons why that disclosure should not be provided); and

- requests that issuers include risk-factor disclosure which indicates how an issuer's valuations of structured notes are reflected in post-offering pricing, valuation and trading.

Plan of Distribution and Dissemination of Final Pricing Terms

The SEC's letter seeks information as to the circumstances under which different investors may receive different prices for a security – such as in the case of a "variable price re-offer," or sales that are made at a volume discount. In addition, for those issuers that may change the price of an offering after the initial offering, the SEC's letter seeks additional information as to how and when this is done.

As a general matter, the SEC letter seeks information as to how pricing information is disclosed to investors, such as the point in the sales prices at which information that is "ranged" in the red herring (such as an interest rate or a capped return) is disclosed to investors, and how the range and the actual final terms are determined. This point is reminiscent of the issues that many market participants addressed when Rule 159 was enacted as part of "Securities Offering Reform" in December 2005.

Hypothetical Historical Performance

The SEC has observed that a variety of indices used in structured note offerings, particularly proprietary indices, have limited historical information. The SEC's letter requests that issuers explain what historical information they have presented in their offering documents for these types of underlying assets and what steps were taken to ensure that the information was presented in a "balanced manner."

Required Exhibits

In 2011, many structured note issuers revised their practices as to the filing of "validity opinions" following the SEC's review of existing practices and Staff Legal Bulletin No. 19 described above. Continuing in that direction, the SEC's letter requests information as to issuer practices relating to documents such as distribution agreements and forms of notes, and whether their practices are consistent with the SEC's form requirements and Item 601 of Regulation S-K.

[6] That report may be found at the following link: http://www.sec.gov/news/studies/2011/ssp-study.pdf. We discussed the OCIE report in our August 2, 2011 issue of Structured Thoughts (http://www.mofo.com/files/Uploads/Images/110802-Structured-Thoughts.pdf).

Due Date

The SEC has requested written responses within 10 business days from the date of its letter. Some issuers may struggle to satisfy that deadline, particularly those with multiple channels of distribution, multiple product types, or different underwriters offering their structured products.

Public Availability of Response Letters

We expect that the SEC will publicly post issuers' responses to these letters, together with any follow-up correspondence, once the review process is completed. We expect that, consistent with the Staff's typical practice in connection with the review of filings, all correspondence will need to be submitted to the Staff using the EDGAR System and will ultimately become public upon the conclusion of the Staff's review. If a response includes confidential, competitively sensitive information, then it may be possible to submit that information under a request for confidential treatment pursuant to Rule 83.

Expected Impact

It is quite possible that the written responses to the SEC's letter will result in issuer-specific requests from the SEC to change their practices. Upon review of the industry's responses, the SEC may also set forth its views on these topics to market participants, generally.

By its terms, the letter relates only to registered offerings of structured notes. However, any changes that are made to the prospectuses for registered offerings may also be adapted by market participants to the offering documents for unregistered offerings, such as structured bank notes and structured certificates of deposit.

Of course, the SEC's letter itself sets forth the Staff's current positions on a variety of issues that frequently arise. Accordingly, even before the SEC responds to the planned submissions, it is entirely possible that a number of issuers will plan to revise certain of their disclosures and other practices to conform to the principles in the SEC's letter. Whether or not they received a letter from the SEC, we anticipate that issuers and underwriters will be carefully reviewing their current practices in light of the letter.

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