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Structured Thoughts

News for the financial services community.

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Due Diligence Procedures for Structured Note Distributors

Sections 11 and 12 are the main liability provisions under the Securities Act of 1933, as amended (the "Securities Act"). Section 11 covers misstatements or omissions in registration statements, while Section 12 imposes liability with respect to misstatements or omissions in prospectuses. Other sources of liability under the federal securities laws include the antifraud provision of the Securities and Exchange Act of 1934, as amended, found in Section 10b and Rule 10b-5 adopted thereunder. Underwriters can be held liable for these misstatements or omissions, but have a potential defense from liability if they can demonstrate that after performing appropriate due diligence procedures, they were unaware of the misstatement or omission. In addition, prior to making a recommendation with respect to a debt security, FINRA expects brokers to assess the credit quality of an issuer, and to ensure that its registered representatives are duly advised of that assessment, and any changes to it.[1]

In this article, we summarize some of the main practical steps that these broker-dealers take to establish a due diligence defense under the Securities Act, and to assess issuer credit quality.

Broker-dealers that are in privity of contract with the issuer, such as under a program distribution agreement or similar document, will have a variety of contractual rights that help them to assess the issuer. The broker-dealer receives representations and warranties from the issuer under the applicable agreement about its business and finances, and the adequacy of the disclosures in the offering documents, which are typically "brought down" at the time of each offering. The agreement will also entitle the broker to periodic comfort letters, legal opinions and officer's certificates. The broker

[1] See, for example, FINRA's 2011 consent agreement relating to sales of notes issued by Lehman Brothers and sold by third party broker-dealers. (http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123478.pdf).

will maintain a file containing the periodic bring-down documents that it receives under the program agreement or similar documents.

Additional procedures, including for broker-dealers that do not have a direct contractual agreement with the issuer, may include:

- Maintaining a summary of the termination provisions in the distribution/selling agent agreement.
- Scheduling periodic or quarterly business due diligence calls with the issuer, or participating in any periodic or quarterly business due diligence calls arranged by the issuer.
- Reviewing the issuer's periodic filings with the SEC, including its Form 10-Ks, Form 10-Qs and proxy statements filed with the SEC.
- Establishing an alert system to track the issuer's press releases, earnings releases, any ratings agency actions, any significant acquisitions/dispositions, any management changes or any other events triggering a Form 8-K filing.
- Regularly conducting due diligence on the distributors/broker-dealer network used in connection with the relevant program or offering.
- Monitoring the issuer's credit rating and CDS spreads.
- Listening to the issuer's earnings calls and reviewing the issuer's investor presentations made publicly available.

These procedures are all designed to help ensure that a broker can assess an issuer's credit quality, and the accuracy of its disclosures. In addition, particularly if the broker's view of the issuer's credit quality or prospects decrease, it must ensure that any such conclusions are properly conveyed to its sales force, so that these conclusions can help inform any recommendations that are made as to that issuer's securities. Brokers will maintain a system to inform their registered representatives of these changes.

A variety of additional steps may be appropriate, depending upon the circumstances. For example, the broker may wish to consider whether changes in the issuer's disclosure documents for the offering are advisable. If the broker on-sells the products to other brokers, it may wish to ensure that those third-party brokers are aware of the relevant changes (which they may well be, due to their own similar practices). In some cases, more significant steps may be appropriate, including contacting individual offerees to ensure that they are aware of the relevant changes and are still interested in participating in the transaction, reviewing the issuer again under the broker's new product approval committee process, or even postponing or cancelling the proposed offering or offerings.

Key Issues for Yankee CDs

Yankee CDs are certificates of deposit issued by U.S. branches of non-U.S. banks. Some Yankee CDs are issued by a federally licensed branch that is subject to regulation by the Office of the Comptroller of the Currency (the "OCC"). Other Yankee CDs are issued by a branch that is regulated at the state level. These instruments may be sold through one or more registered broker-dealers, which may or not be affiliated with the issuer. A Yankee CD may be a "plain vanilla" instrument with a fixed or floating rate of interest, or it may be a structured CD that is linked to one more underlying assets.

While these instruments typically do not have the benefit of FDIC insurance, they are designed to have the preferences for deposits that apply under applicable banking laws.

In this article, we discuss a few recurring issues that arise in connection with the structuring and offering of these instruments.[2]

Are Yankee CDs Securities?

An issuer will want to consider whether the proposed Yankee CDs are "securities" under the U.S. Securities Act of 1933 (the "Securities Act") or the U.S. Securities Exchange Act of 1934 (the "Exchange Act"). If issued by a regulated branch and considered securities within the meaning of the Securities Act, they would still qualify for the exemption from registration provided by Section 3(a)(2) of the Securities Act. However, if the issuer is a federally licensed branch regulated by the OCC, and the instruments are deemed to be securities, then even if exempt from SEC registration under the Securities Act, they would need to be registered with the OCC under Part 16 of the OCC's securities offering rules, or they would need to be issued under an exemption from those rules. In addition, whether these are securities may affect the degree to which FINRA's rules and regulations apply to any offering of the instruments. For example, although FINRA's conduct rules and communications rules would apply to Yankee CDs, if they are not securities, other FINRA regulations, such as the Corporate Financing Rule (and any related filing requirements arising from that rule), would not apply.

Factors that may affect this determination will include:

- whether the Yankee CDs are "principal protected," or whether they may pay less than principal;
- how the Yankee CDs are marketed;
- the extent to which the CDs are transferable; and
- how the CDs are recorded on the issuer's own books and records.

Issuers of Yankee CDs are likely to avoid the types of activities that resulted in the determination that a certificate of deposit was a security in cases such as "Gary Plastics."[3] These activities would include, for example, representing to investors that a secondary market will always be maintained for them.

There is only a limited amount of authority from the OCC and banking regulators that addresses whether a Yankee CD is a security. Depending on the facts, different counsel may reach different conclusions, and with different degrees of certainty. However, in practice, these instruments are typically offered in large denominations,[4] in transactions that are privately negotiated with sophisticated investors. As a result, they can typically be offered within the parameters of one or more of the existing exemptions from the OCC's registration requirements,[5] where sufficient uncertainty exists as to their proper characterization.

Disclosures

There is no single set of regulations that cover the necessary disclosures for Yankee CDs. Accordingly, disclosure practices vary in this area. However, because Yankee CDs tend to be sold to institutional and other accredited investors, they tend to involve shorter "disclosure packages" than instruments such as retail structured products tend to have. And of course, the amount of disclosure will depend in part on the complexity of the instrument's terms, and the nature of any underlying asset.

Key disclosure issues tend to involve:

- the absence of FDIC insurance;

[2] For a discussion of structured CDs, particularly those that may be offered to retail investors, please see our "Frequently Asked Questions about Structured Certificates of Deposit," which may be found at: http://www.mofo.com/files/Uploads/Images/Frequently-Asked-Questions-about-Structured-Certificates-of-Deposit.pdf.
[3] See Gary Plastics Packaging v. Merrill Lynch, Pierce, Fenner & Smith Inc., 756 F.2d 230 (2d Cir. 1985).
[4] See discussion below under "Minimum Denominations."
[5] We describe these exemptions in our "Frequently Asked Questions Relating to Section 3(a)(2) Bank Note Programs—Regulations Governing Offerings Under Bank Note Programs," which may be found at: http://www.mofo.com/files/Uploads/Images/FAQs-Section-3(a)(2)-Bank-Note-Programs.pdf.

- the risk factors that arise from the terms of the instrument, including their limited liquidity; and
- the availability of public information about the issuer and its finances, so that an investor may make an appropriate determination about the issuer's creditworthiness.

The Federal Reserve Board's Regulation DD, which implements the Truth in Savings Act, contains disclosure and advertising requirements for deposit accounts that are offered to "consumers." For purposes of Regulation DD, the term "consumers" is defined as natural persons "who hold an account primarily for personal, family or household purposes, or to whom such an account is offered."

As discussed above, these types of CDs are generally not offered to "consumers." Accordingly, although any disclosure documents obviously should accurately reflect the terms of the instrument and any related risks, the specific disclosure requirements of Regulation DD will not generally apply.

Minimum Denominations

Deposits made with a branch of this kind are not typically insured by the FDIC. Accordingly, they are subject to the International Banking Act, which restricts the offering of "retail deposits", in which the initial deposit is less than $250,000, the current FDIC insurance limitation. As a result, in order to avoid the classification as a retail deposit, these instruments are subject to a minimum deposit amount of $250,000.

Blue Sky Regulation

Even if the Yankee CDs are deemed to be "securities" for state blue sky purposes, an exemption from state filings will typically exist. For example, most states have an exemption for bank-issued securities that is similar to the exemption found in the Securities Act.

The SEC and FINRA: Protect Your Elders

In April 2013, the SEC, in association with FINRA, held a Compliance Outreach Program for broker-dealers. The program included a panel that addressed sales practices generally, and as they relate to complex structured products.

Consistent with recent regulatory activity, both the SEC's David Blass and FINRA's Susan Axelrod highlighted their current focus on the practices surrounding the sale of certain types of structured products to senior citizens. More specifically, Ms. Axelrod, citing the fact that the population is aging, noted that FINRA is currently in the process of gathering information on market practices related to elderly clients.

Industry panelists suggested that very complex products should not be sold to customers above a certain age. Other suggested practices include account monitoring for excessive concentrations of particular product types and certain asset classes, as FINRA has previously advised.

In recent years, many of FINRA's regulatory actions concerning unsuitable sales of structured products arose in part from unsuitable sales to senior citizens.[6] In these cases, for example, the stated investment preferences and risk tolerance of the relevant investors was strikingly different from the products that were offered to them. It is likely that FINRA will continue to focus on sales to seniors as the population ages and as products get more complex.

[6] See, for example, the following FINRA consent agreements:

- http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p125264.pdf.
- http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123490.pdf.
- http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p122292.pdf.
- http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=15482.

We have described these issues in prior issues of Structured Thoughts. See http://www.mofo.com/files/Uploads/Images/120119-Structured-Thoughts.pdf.

The Financial Stability Oversight Council's 2013 Annual Report: Increasing Exchange-Traded Product Activity

In its 2013 Annual Report, the U.S. Financial Stability Oversight Council (the "FSOC") summarized, as part of its review of investment funds, activities in exchange-traded products ("ETPs"). ETPs include exchange-traded funds and exchange-traded notes. According to the report, the number of U.S.-listed ETFs grew significantly in 2012 to 1,131 products, with ETF assets growing by 22% to $1.29 trillion. The report also noted the expansion of ETPs in recent years into a variety of different types of underlying assets, and the concentration of ETPs among a limited number of sponsors.

The FSOC noted several potential innovations in ETPs. For example, some ETP providers have approached the SEC with proposals for new ways to operate actively-managed ETPs, such as disclosing holdings less frequently or disclosing a portfolio that closely replicates an underlying index daily. An approach of this kind could balance the need for protecting the ETP provider's active strategy with the need to create both a transparent and a liquid basket of assets. Currently, actively-managed ETFs and certain index-based ETFs disclose their holdings on a daily basis.

The Annual Report is available at:
http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202013%20Annual%20Report.pdf.

SEC Discusses Estimated Value at Structured Products Conference

On May 2, 2013, Amy Starr, Chief of the SEC's Office of Capital Markets Trends, spoke by teleconference at *Structured Products* magazine's Americas conference.

Her remarks included a few items that are relevant for many issuers.

- *Timetable for New Disclosures.* The new estimated value disclosures mandated by the SEC's February 2013 follow-up letter to issuers should be added within four months or so. As many readers are aware, a number of major issuers have already commenced rolling out their new disclosures.

- *New Letters for Non-Recipients of the Prior Letters.* Issuers that were not recipients of the April 2012 letter[7] would likely receive a letter relating to the disclosures, with instructions along the lines of the SEC's recent guidance.

- *Application to Other Products.* The SEC is not expected at this point to extend its views relating to estimated values to other product categories. The staff is principally concerned with instruments that contain an embedded derivative. Accordingly, simple LIBOR floating rate notes, for example, would not be subject to the new guidance.

- *Substantive Review of Products/IOSCO Toolkit.* The SEC has reviewed the "regulatory toolkit" recent published by IOSCO.[8] The SEC does not intend to change its existing practices, and begin to approve of or disapprove of particular products. Instead, the SEC will continue its traditional approach of focusing on adequate disclosure of the terms of the instrument and their risks, and method of valuation.

[7] You know who you are.
[8] We discussed this consultation in our recent client alert, which may be found at: http://www.mofo.com/files/Uploads/Images/130506-IOSCO-Consultation-Report-on-Financial-Benchmarks.pdf.

Nominations

On Monday, May 20, *Derivatives Week* will begin accepting nominations for their 2013 rankings and Global Derivatives Awards. We invite you to submit a nomination through this survey, https://adobeformscentral.com/?f=HgmXrT2-ry59eDnDw4JQsA.

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

Morrison & Foerster named Structured Products Firm of the Year, Americas, 2012 by *Structured Products* magazine for the fifth time in the last eight years. See the write up at http://www.mofo.com/files/Uploads/Images/120530-Americas-Awards.pdf.

Morrison & Foerster named Best Law Firm of the Americas, 2012 by *StructuredRetailProducts.com*.

Morrison & Foerster named Legal Leader, 2013 by *mtn-i* at their Americas Awards. Two of our 2012 transactions were also granted awards of their own as a result of their innovation.

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