

# Structured Thoughts

*News for the financial services community.*



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## **The 1996 Morgan Stanley Letter: Re-imagined at the Age of 18**

### **Introduction**

The “Morgan Stanley” letter provides the securities law disclosure guidance for most issuances of equity-linked registered structured notes in the U.S. market. Its provisions are often consulted in considering the permissibility of registered notes linked to a single stock, a basket of two or more stocks, and even equity indices.<sup>1</sup>

The Morgan Stanley letter provides that robust disclosure about the issuers of the underlying stock or stocks is not required where those issuers are SEC-reporting companies (registered under the Exchange Act) and the issuers either (a) are eligible to use Form S-3 or Form F-3 for primary offerings of non-investment grade securities or (b) meet the relevant listing standards for equity-linked securities. If these conditions are satisfied, an issuer of a note linked to the underlying stock may include only:

- a brief discussion of the underlying issuer’s business;
- a reference to the availability of information about the underlying issuer that has been filed with the SEC; and
- information regarding the market price of the underlying stock, as required under SEC Regulation S-K.

<sup>1</sup> The Morgan Stanley letter may be found at the following link: <http://media.mofo.com/files/Uploads/Images/Morgan-Stanley-6-24-1996.pdf>.

The letter was issued in 1996. Since that time, substantial changes have occurred as to how investors obtain information about SEC-reporting companies. These changes have substantially increased the ease with which investors can obtain this information. This article discusses those changes, and considers what the Morgan Stanley letter might have looked like if it were issued today, in light of the availability of information to modern-day investors.

### **1996: Obtaining Information About Public Companies**

Many readers of this publication may remember that it wasn't as easy in 1996 as it is today to obtain information about public companies.

Electronic Exchange Act filing via EDGAR was not mandatory for all public companies until 2002, when foreign private issuers became subject to mandatory electronic filing. If you wanted to review an issuer's financial statements before it was an EDGAR filer, you could mail order them from the SEC, or visit the SEC's public reference room in Washington or at certain other locations. You could also purchase these reports from certain commercial distributors.

In addition, surfing the Internet in 1996 wasn't as easy as it is today. Some readers may remember how much time it took to download a long filing such as an annual or quarterly report, and the not-so-user-friendly formatting of financial statements and other tables on the EDGAR system at that time.

Since 1996, in addition to mandatory EDGAR filings, virtually all investors have easy access to EDGAR filings from their desktop, due to the popularity of browser software, which many take for granted today. In addition, most public companies have an "investor information" section on their website, where investors can conveniently obtain business and financial information about the company. Moreover, companies often have a Facebook page, a LinkedIn page, and a Twitter account, and use other social media channels. All of these make information available almost instantaneously.

Investors do not have to turn to an issuer's annual report to see historical stock prices or recent stock prices. A variety of widely used news websites and business and investor websites all make this information easily available. Many of these services provide convenient (and often free) tools for accessing other useful information about historical stock prices, including graphs, and the ability to compare the performance of a particular stock against the performance of its peers, or against a relevant sector index or broader market index.

The enhanced availability of information is not limited to companies registered under the Exchange Act. In 2008, the SEC modernized its exemption for foreign private issuers under Exchange Act Rule 12g3-2(b). This provision enables companies that are public outside of the U.S., but who have a significant number of U.S. shareholders without having had a public offering in the U.S., to avoid registering under the Exchange Act if they satisfy certain requirements. These requirements include maintaining a website with English language business and financial information that can be accessed by U.S. shareholders. These companies now include a significant number of non-U.S. issuers that have ADRs which trade in the U.S. over-the-counter market with "Level I" ADR programs, but do not file periodic reports with the SEC.

In a nutshell, the amount of information about virtually all public companies, and the ease with which an individual investor can access that information, has expanded beyond the imagination of a securities lawyer or regulator in 1996.

### **What Would a Morgan Stanley Letter Look Like Today?**

The Morgan Stanley letter rests on the SEC's conclusions as to whether there are sufficient U.S. market interests in and sufficient publicly available information about the issuer of the underlying stock. If we could engage in some time travel, and bring today's informational resources back to 1996, the Morgan Stanley letter might have had somewhat different contents.

*One Year as a Public Company.* The Form S-3/Form F-3 prong of the Morgan Stanley letter is understood to contemplate a one-year "seasoning period" of public company status for an underlying stock. However, fairly similar information will exist as to a public company today immediately upon effectiveness of a registration statement, and will be available to an investor with just a couple of clicks on a PC. That is, the IPO registration statement and prospectus will include several years of audited financial statements and robust information about a company's business and management, similar in scope to the Exchange Act reports filed by a company with a longer reporting history. As for recent examples, consider

the IPOs of companies such as Google and Facebook during the last few years. The information in these companies' SEC filings had been widely studied and followed by institutional and retail investors even before the effective date of the IPO.

*Market Capitalization.* Form S-3/F-3 eligibility for a primary offering requires a public float of at least \$75 million. This amount is considered a proxy for the magnitude of public interest in a company. In today's market, that number may not be considered very large, or difficult to achieve. For example, the smallest companies in the S&P MidCap Index have a market capitalization of \$1.2 billion or more.

However, can we imagine smaller companies that have comparable publicly available information and a significant degree of market interest? Factors such as the number of analysts that maintain coverage of a company and companies that have significant trading volume and that have not made any announcement of an event (such as a late annual or quarterly report) that might call into question the reliability of its public filings all might end up being potential candidates for linking under a reconsidered Morgan Stanley letter.

*Registration Under the Exchange Act.* The Morgan Stanley letter presumes that there would only be sufficient information about companies that are registered under the Exchange Act. But perhaps that presumption is less relevant than in the past. At the time of the Morgan Stanley letter, foreign private issuers that sought an exemption from registration under the Exchange Act needed to comply with Rule 12g-3-2(b)'s provisions, which have been amended since that time. Under the current rule, "12g-3-2(b) companies" must make English language financial statements and other information available on a public website. A significant number of major international "blue chip" companies utilize this exemption, for example, in connection with a Level I ADR program in which their ADRs are traded in the over-the-counter market in the U.S. These companies, especially the ones that are of the most interest to U.S. investors, typically have disclosures that are regulated by an experienced non-U.S. regulator or stock exchange, and that are audited by a major accounting firm. There may be a set or subset of these companies that could be deemed worthy of the Morgan Stanley letter's exemption.

In addition, because Exchange Act registration is a requirement of the Morgan Stanley letter, exchange traded funds, which register their securities under the Exchange Act, are eligible for linking, but more traditional mutual funds, which register with the SEC only under the 1940 Act, remain ineligible. In today's market, information about these types of companies is readily available to investors through a combination of EDGAR filings, websites maintained by the fund sponsor, and business and financial portals.

### **Policy Implications and Alternative Investment Structures**

Because the Morgan Stanley letter is not available for the underlying assets described in this article, issuers who wish to link to them in order to meet an investor's investment goals need to do so using a non-registered program, such as structured CD, bank notes, Rule 144A, or Regulation D. These types of instruments are not necessarily subject to the requirements of the Morgan Stanley letter. (Of course, linking to these types of underlying assets does raise disclosure questions and suitability questions that must be appropriately addressed by the issuer and the underwriter before any offering is completed.)

From an investor protection perspective, investors may be better served if these types of instruments could be issued under a registered program. Investors would obtain the liability protections of Section 11 and Section 12 of the Securities Act, and the offering documents would need to include (or incorporate by reference) the full "disclosure package" of a registered offering. Because these offering documents would be publicly available on EDGAR, activity could be easily monitored by the SEC and other market participants. An updated Morgan Stanley letter would remove these offerings from the shadows, and reflect the changes to the marketplace since 1996.

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## Structured CDs – Goodbye Regulation DD, Hello Regulation DD

Issuing banks are required to make certain disclosures with regard to all CDs that are offered to consumers, including structured CDs. Regulation DD, adopted under the Truth in Savings Act (the TISA), prohibits an issuing bank from advertising its deposit accounts in any way that is inaccurate or misleading.

The regulation also contains a variety of specific disclosure rules with which issuers of CDs must comply. For example, banks may not use the word “profit” in referring to interest payments, or use the words “free” or “no cost” if a maintenance or activity fee is imposed on the account. Banks are also obligated to comply with advertising rules regarding rates of return. For example, an issuing bank must state certain types of interest payments as an “annual percentage yield,” and disclose any and all fees associated with the deposit, such as ladder rates on various CDs, as well as any penalty fees that may be imposed for early withdrawal.

In May 2014, the Board of Governors of the Federal Reserve System repealed its Regulation DD. Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act transferred rulemaking authority for a number of consumer financial protection laws, including the TISA, from the Federal Reserve to the Bureau of Consumer Financial Protection (the CFPB). In December 2011, the CFPB published an interim final rule establishing its own Regulation DD to implement the TISA. This version of Regulation DD is substantially similar to that of the Federal Reserve.

The CFPB's new Regulation DD may be found at 12 CFR Part 1030, as well as through the following link:  
[http://www.ecfr.gov/cgi-bin/text-idx?tpl=/ecfrbrowse/Title12/12cfr1030\\_main\\_02.tpl](http://www.ecfr.gov/cgi-bin/text-idx?tpl=/ecfrbrowse/Title12/12cfr1030_main_02.tpl).

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## FCA Issues Fine in Relation to Structured Product Transaction

The UK's Financial Conduct Authority (FCA) has announced that it has fined a product manufacturer and a product distributor in relation to disclosures in respect of a structured products transaction. This action is consistent with the increased focus by the FCA and other regulators in Europe in relation to structured products, particularly those targeted at retail investors.

The FCA's action related to a cliquet product (a series of forward start options) which provided capital protection and the potential for further returns depending upon the performance of the FTSE 100 Index. However, the FCA determined that the probability of an investor receiving the minimum return was 40% to 50%, and the probability of receiving the maximum possible return was close to zero. Notwithstanding this, promotional materials prepared by both the product manufacturer and the distributor highlighted the potential maximum return as a key promotional feature. The FCA also noted that some of the materials did not clearly explain how returns were calculated.

The FCA noted that the product was typically sold to unsophisticated, risk-averse investors with limited experience and knowledge of financial products. The FCA stated that it is crucial that firms consider the needs of their customers during both the design and the marketing and sale of the product. The FCA also noted that financial promotions are often the primary source of information for consumers and that, in this case, the manufacturer and the distributor had failed to ensure that the disclosures were clear, fair, and not misleading.

The whole area of disclosure in respect of retail structured products is one that has been the subject of intense debate in EU recently, with the finalization in April 2014 of the text of the Regulation on key information documents for packaged retail investment and insurance based investment products (PRIIPS), which will require the publication of a short form key information document (KID) to investors prior to the sale to them of packaged retail investment products. The action of the FCA described above is a reminder that regulators are already very focused on disclosures in respect of these products and are likely to maintain a highly interventionist approach in this area.

## ESMA Opinion on Good Practices for Product Governance Arrangements in Relation to Structured Retail Products

On 27 March 2014, the European Securities and Markets Authority (ESMA) published an opinion in relation to good practices for product governance arrangements for structured retail products. This paper was a follow-up to some of the issues raised by ESMA in its July 2013 report on "Retailisation in the EU." The opinion paper sets out a broad set of non-exhaustive examples of good practices that ESMA believes firms should put in place to enhance investor protection, particularly in relation to the complexity of structured retail products they manufacture or distribute, the nature and range of the investment services and activities undertaken in the course of that business, and the type of investors they target. ESMA states that the good practices should be a helpful tool for competent authorities in carrying out their supervisory action.

The good practices recommended in the opinion cover (i) the general organization of product governance arrangements, (ii) product design, (iii) product testing, (iv) identification of target market, (v) distribution strategy, (vi) value at the date of issuance and transparency on costs, (vii) secondary market and redemption, and (viii) the review process. The overall themes of the opinion include the need for transparency and consistency in product governance arrangements, ensuring that in developing the product, priority is given to meeting the financial needs, investment objectives, and knowledge and experience of the target market and taking into account potential risks arising from the way that products are distributed (whether directly or indirectly) to investors.

The ESMA opinion is consistent with the approach already taken by some competent authorities in the EU. The UK's Financial Conduct Authority (FCA) (through its predecessor, the Financial Services Authority) has already published similar guidance on structured products. Many of the recommendations in the opinion are also consistent with principles for managing the provider/distributor relationship and distributor/individual investor relationship previously published by the Joint Associations Committee on retail structured products. It is therefore unlikely to have a major impact on the way structured products are manufactured and distributed in the EU. However, it may be helpful in facilitating a consistent approach for competent authorities in the supervision of structured retail products.

The opinion may be found at the following link: [http://www.esma.europa.eu/system/files/2014-332\\_esma\\_opinion\\_structured\\_retail\\_products\\_-\\_good\\_practices\\_for\\_product\\_governance\\_arrangements.pdf](http://www.esma.europa.eu/system/files/2014-332_esma_opinion_structured_retail_products_-_good_practices_for_product_governance_arrangements.pdf).

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## Joint Forum Endorses the K.I.S.S. Method in Point of Sale Disclosures

*The young jazz student plays an improvised solo that is longer, or more complex than his or her skills would merit. Dismayed by the student's bravado, the class music teacher asks:*

*"Haven't you heard of the K.I.S.S. method? KEEP IT SIMPLE STUPID!"*

*The rest of the band has a small laugh, and the young jazz student resolves to be more concise about soloing.*

Securities offering documents, and especially those for structured products, have been criticized for years for their length and complexity. Market participants and regulators alike wonder if retail investors can understand these documents, and whether the length and complexity discourages retail investors from reading them at all.

In its April 2014 report (<http://www.bis.org/publ/joint35.pdf>), the Joint Forum advocated in favor of short summary documents for use in structured note offerings, among other types of investment products.

The Joint Forum consists of the Basel Committee on Banking Supervision (the BCBS), the International Association of Insurance Supervisors (the IAIS) and the International Organization of Securities Commissions (IOSCO).



The report identifies differences and gaps in the regulatory approaches to point of sale (POS) disclosure for different types of products found in the insurance, banking, and securities sectors. It sets forth eight recommendations, for use mainly by policymakers and supervisors, to assist them in considering, developing, or modifying their POS disclosure regulations:

1. Jurisdictions should consider requiring a concise written or electronic POS disclosure document for the products.
2. The POS disclosure document should be provided to consumers free of charge, before the time of purchase.
3. A jurisdiction considering POS disclosure should consider requiring that a POS disclosure document disclose key characteristics, including costs, risks, and financial benefits or other features of the product.
4. The POS disclosure document should be clear, fair, not misleading, and written in a plain language designed to be understood by the consumer.
5. The POS disclosures should include the same type of information to facilitate the comparison of competing products.
6. The POS disclosure document should be concise, set forth key information about a product, and may include, as appropriate, hyperlinks or references to other information. The POS disclosure document should make clear that it does not, in and of itself, provide complete information about the product.
7. Allocation of responsibility for preparing, making available, and/or delivering the POS disclosure document should be clearly established, and the POS disclosure document should identify which entity is responsible for its content.
8. A jurisdiction considering POS disclosure should consider how to use its regulatory authority to implement these POS recommendations.

Several regulators have already taken action that is consistent with the report. For example, in April 2014, the European Parliament approved an EU regulation relating to packaged investment products. The regulation will require product manufacturers and distributors to produce and provide to retail investors key information documents (KIDs) for certain types of structured products.<sup>1</sup> Some would say that SEC Regulation S-K, which governs the cover page and the summary section of prospectuses, is designed in part (or used in practice) to achieve a comparable goal.<sup>2</sup>

In some markets, the private sector has made its own efforts to provide summary reference materials for structured products. In the U.S., following the adoption of the 2005 "Securities Offering Reform" rules, many market participants introduced summary materials in the form of free writing prospectuses. These documents are designed to effectively communicate the key terms and key risks of an offering, and often to help differentiate the product offerings of a broker from one another.

Additional changes may be forthcoming in the U.S. The SEC continues to monitor its disclosure rules, including the requirements of S-K.<sup>3</sup> The Dodd-Frank Act provides the SEC with explicit authority to require broker-dealers to provide certain disclosures to retail investors before the purchase of an investment product or service.

The Joint Forum's report reflects the desire, found among retail investors worldwide, for materials that will help them to digest the terms of what may be a complex instrument. These materials are not expected to set forth everything that an investor might wish to know, but can serve as a useful tool to facilitate an investor's understanding.

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<sup>1</sup> Our summary of the regulation may be found at the following link:

<http://www.mofo.com/~media/Files/Newsletter/140602StructuredThoughts.pdf>.

<sup>2</sup> See Items 501(b) and 503(a) of Regulation S-K.

<sup>3</sup> See, for example, the SEC's "Report on Review of Disclosure Requirements in Regulation S-K," available at: <http://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf>.

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Morrison & Foerster has been named **Structured Products Firm of the Year, Americas, 2014** by *Structured Products* magazine for the sixth time in the last nine 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, and 2014** by *Structured Retail Products.com*.

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

Morrison & Foerster named **European Law Firm of the Year, 2013** by *Derivatives Week* at its Global Derivatives Awards.

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