Morrison & Foerster News Bulletin Volume 7, Issue 2 February 10, 2016

Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Is There a Standard Form of Rule 144A Representation Letter?

My file of Rule 144A representation letters has been growing fatter, and I'm not sure why.

I would have hoped that by now there would be just one great form that I could point to, and recycle the rest of them. After all, it should be kind of simple – investor represents to broker-dealer that it's a QIB. The broker-dealer files the letter in a safe spot, and the purchase price for the securities is wired. (Maybe there's also a closing dinner?)

So, why are so many forms floating around?

Aside from many lawyers' natural instinct to add text and make comments, there are a variety of reasons why some letters differ from one another.

Additional Legal Qualifications. The representation letter may need to cover more ground than just QIB status. For example, the relevant securities that are being offered may be limited to "qualified purchasers" under the 1940 Act, "eligible contract participants" for commodities purposes, etc.

FINRA Suitability Rules. By selling to an "institutional account" that is exercising independent judgment, a broker-dealer may have fewer obligations under FINRA's suitability rules. For example, the broker-dealer may be selling to a registered investment adviser that is exercising investment discretion for one of its customers. The broker-dealer may wish to have the investor acknowledge this, in order to help document and record the broker-dealer's process in making the sale.

Are You Sure You Know What You're Doing? A key notion behind Rule 144A is that QIBs are more likely to understand what they are buying. Still, in the event of a complex transaction, the broker-dealer may often want to memorialize this point. Similarly, in the case of a reverse inquiry transaction, it may be worthwhile to note that the terms were proposed by the investor, and not the issuer. In the case of an offering of a structured product with a complex underlier, such as the broker-dealer's own proprietary index, the broker-dealer would often like the investor to acknowledge that it understands that underlier, and that it had all the information it needed about the index prior to making an investment decision.

Legal Obligations of the Investor. The investor, especially if it operates in a regulated industry, may be subject to a variety of legal and contractual obligations that may impact its ability to invest in different types of instruments. Accordingly, the broker-dealer may ask the investor to represent that it has done its homework, and confirm that the investment is permissible for it under the circumstances.

Long-Term Relationship? The representation letter may be intended to last for a long time, and cover many years of offerings, as opposed to a single discrete offering. The broker may want the investor to have a "duty to update" the representations in the letter if its QIB (or other) status ever changes.

Feeling Conflicted. In connection with a variety of transactions, the broker-dealer or its affiliates may wear multiple hats, and may (quite lawfully) have multiple interests. For example, the broker-dealer's research division may have expressed a rating or recommendation as to an underlying asset that is the opposite of the view underlying a structured note. The broker-dealer may wish to memorialize the fact that the investor fully understood the situation, in order to avoid future claims from being made to the contrary.

Informational Advantages. A broker-dealer, somewhere in its organization, may have material non-public information relating to the relevant issuer, or the relevant underlying asset. Notwithstanding the existence of appropriate ethical walls, the broker-dealer may wish to have the investor record the fact that it was aware of this possibility.

Resale Restrictions. The offered security may be subject to a variety of resale restrictions under applicable securities, investment company, commodity or other laws. Violation of these transfer restrictions could, in some cases, involve the issuer or the broker-dealer in legal proceedings that they would obviously prefer to avoid. Accordingly, the letter may explicitly restate these restrictions, and/or obligate the investor to properly observe them.

ERISA Concerns. The broker-dealer and the issuer wish to avoid any implication that they are acting as a fiduciary to an investor that is subject to ERISA. Accordingly, they may wish to have the investor represent that it is not an employee benefit plan that is subject to ERISA.

Who Can Rely? The broker-dealer selling the instrument may have good reason to be looking out for the welfare of parties other than itself. Accordingly, the representation letter may include third party beneficiary provisions that entitle the issuer of the security and potentially other parties to rely on the representations that are set forth in the letter.

Issuer Representations and Frequent Issuers

Introduction

In the prior article, we discussed the representations that sophisticated investors may provide to broker-dealers in connection with securities offerings. We now turn our attention to the representations made by the issuers.

For most structured note programs, whether offered on a registered basis or a non-registered basis, the issuer makes a variety of representations about its business, finances and the offering documents. These are typically set forth in a program agreement or similar agreement with the distributors. These representations may be quite lengthy and detailed, or in the case of many seasoned issuers, may be more limited.

This program agreement is executed at the commencement of the program, while the actual offerings may take place over a period of years. Accordingly, how do the underwriters receive the benefit of these representations in subsequent offerings?

Automatic Representations

The designers of today's program agreements anticipated this question. Structurally, these agreements are typically constructed such that the issuer automatically repeats the representations to the underwriters as of specified dates following the initially signing date: typically, the pricing date of any offering, as well as its closing date. These automatic representations replicate in a sense the manner in which representations are given in a classic "bullet" underwriting, where there is no program: the issuer is required under the terms of the underwriting agreement to make its representations as of the pricing date (when the agreement is signed) and as of the closing date.

As a result of these deemed representations in a program, the issuer effectively must monitor its business and affairs, particularly to ensure that it is not making statements in the offering documents (including any periodic reports that are incorporated by reference) that are no longer correct.

Terms Agreements

Many program agreements address the question of subsequent representations by having the issuer execute a short "terms agreement" at the time of each pricing. These agreements are often created in the form of an exhibit to the program agreement, with fairly simple blanks that can be filled at the time of each offering. Under these short agreements, the issuer may repeat the program agreement's representations as of the pricing date.

Practice varies as to terms agreements. Some structured note underwriters insist on receiving them in connection with each structured note takedown, whether the principal amount is large or small, and whether the offering is underwritten or agented. Some underwriters dispense with terms agreements, relying instead on the "automatic representations" in the program agreement, together with the ongoing due diligence performed by both the investment bank and designated underwriter's counsel. In the view of the latter group, the time and expense involved in creating these terms agreements is not necessarily justified by the benefit provided. For example, under the analysis applied in the "Worldcom" case,[1] an underwriter's due diligence is judged by the adequacy of its investigation of the issuer's business and affairs, and not necessarily the frequency of the written representations and other "due diligence" documents that it receives.

Impact of Representations

Whether the representations are being provided automatically, through the program agreement's terms, or through a deal-specific terms agreement, the issuer is "on the hook" to the underwriters (and to potential investors) as to the accuracy of the offering documents, and as to the other representations. Accordingly, all issuers of structured notes maintain reporting mechanisms to ensure that they are effecting their offerings at appropriate times, when these representations can be appropriately relied upon.

Rule 15a-6 and Structured Note Sales Into the United States

Introduction

Rule 15a-6 under the Exchange Act sets forth the (limited) activities that foreign broker-dealers may undertake in the United States, and still remain outside the scope of the Act's broker-dealer registration requirements.

The rule mainly addresses four areas of activity:

- Effecting unsolicited transactions.
- Soliciting transactions with certain institutional investors (which are then coordinated with U.S. broker-dealers).
- Conducting business with U.S. broker-dealers and banks acting as broker-dealers, and expatriates that are temporarily in the United States.
- Distributing research reports to certain institutional investors.

The first three types of activities at times involve sales of structured notes, and we describe them in this article. Non-U.S. broker-dealers carefully structure these activities around Rule 15a-6, in order to avoid becoming subject to U.S. broker-dealer regulation.[2]

[1] In re WorldCom Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. Dec. 15, 2004).
[2] For additional discussion of this rule, please see our "Frequently Asked Questions About Rule 15a-6", available at: http://media.mofo.com/files/Uploads/Images/150710FrequentlyAskedQuestionsAboutRule15a_6.pdf

Transactions with Retail Customers

Rule 15a-6 permits non-U.S. broker-dealers to transact with retail customers in the United States only on a very limited basis. The rule permits these broker-dealers to engage in (a) unsolicited transactions with retail (or institutional) customers in the United States and (b) under certain circumstances, transactions with expatriates who reside in the United States.

Unsolicited Transactions. The exception for unsolicited transactions applies only to a U.S. investor who has sought out the foreign broker-dealer entirely of the investor's own accord, without any solicitation by the non-U.S. broker-dealer. For example, a U.S. investor may somehow be informed about a type of structured product that is traded outside of the United States, and contact the non-U.S. broker dealer to offer to purchase a quantity of that product. As is the case for a variety of items under the federal securities laws, the SEC interprets the term "solicitation" very broadly. As a result, if the non-U.S. broker agrees to such a transaction, or if it establishes an account with that U.S. investor to facilitate the sale of the investment, the broker must be very careful not to take any action that could be deemed to be a solicitation of any additional transactions. Accordingly, many non-U.S. broker-dealers generally refrain from establishing these types of accounts, in the absence of special circumstances.

A note of caution as to the exemption for unsolicited purchases: Rule 15a-6 itself is only an exemption from registration as a broker-dealer. For any sale to a person in the United States, an exemption from registration under the 1933 Act will still be needed.

Expatriates. In addition to unsolicited transactions, a non-U.S. broker-dealer may transact with certain expatriates who are in the United States. This part of the exception is designed to ensure that non-U.S. broker-dealers do not have to terminate a pre-existing existing business relationship with their non-U.S. customers who happen to travel to the United States, or work in the United States on a temporary basis. These considerations shaped the provisions of Rule 15a-6: to qualify for the exemption, the non-U.S. person must be in the United States on a "temporary basis," and there must be a "pre-existing relationship" between the broker and that person before the move to the United States took place.

If a relationship between a non-U.S. broker-dealer and an expatriate qualifies for the exemption, there are no significant limitations on the nature of the business that the broker-dealer can conduct with that person. For example, there is no need to retain a "U.S. chaperone" to act in connection with these transactions, as discussed below in the case of certain institutional sales.

Transactions with Institutional Investors

Rule 15a-6 enables non-U.S. broker-dealers to solicit transactions with "U.S. institutional investors" and "major U.S. institutional investors." (These terms are defined in the rule.) Visits and telephone conversations with U.S. institutional investors" that are not "major U.S. institutional investors" must be "chaperoned" by a representative of a U.S. broker-dealer.

The key limitation for the use of this exemption is that any transactions that result from the solicitation must be effected through a U.S. broker-dealer.

As in the case above for retail investors, this exemption for institutional investors only relates to the broker-dealer registration requirements, and a separate exemption from Securities Act registration must be obtained for any resulting sale. In the case of structured notes, this will often be the Rule 144A functionality that is built into many EMTN and "Global MTN" programs.

Obligations of the U.S. Broker-Dealer. A U.S. broker-dealer that facilitates a trade with a U.S. institutional investor has a variety of obligations, including the information required for "know your customer" purposes, and obtaining the information or documentation needed for the broker-dealer to satisfy its suitability obligations. The U.S. broker-dealer must ensure that the confirmations and statements that the U.S. institutional investor receives for the relevant offerings comply with applicable legal requirements.

A U.S. broker that engages in this type of trade must satisfy a variety of additional obligations, including:

- determining that the non-U.S. broker-dealer and its associated persons involved in the trade are not subject to a statutory disqualification under Section 3(a)(39) of the Exchange Act or any substantially equivalent non-U.S. provisions;

- obtaining from the non-U.S. broker-dealer the basic background information required under Rule 17a-3(a)(12) under the Exchange Act with respect to each associated person of the non-U.S. broker-dealer who is involved in the trade;
- obtaining from the non-U.S. broker-dealer and each involved non-US. associated person a written consent to service of process by the SEC or other securities regulators; and
- making the information obtained in the second and third bullets above available to the SEC.
    (i) In short, the U.S. broker-dealer will essentially take full responsibility for the executed trade, treating the referred account in the same manner it would treat any of its other accounts.

These requirements are sufficiently cumbersome that a U.S. broker-dealer will not typically enter into such an arrangement with a non-affiliated non-U.S. broker-dealer in the absence of a plan for multiple transactions and repeat business. However, in the case of affiliated entities that operate as part of a multinational financial institution, there is typically greater openness to an arrangement of this kind.

Transactions with U.S. Broker Dealers

The rule also permits a non-U.S. broker-dealer to engage in transactions with U.S. broker-dealers or with U.S. banks acting in a broker-dealer capacity. These transactions may be actively solicited by the foreign broker-dealer, and also provide a basis in which non-U.S. broker-dealers may purchase and sell structured notes with U.S. market participants.

How Many Years?: Disclosing Historic Reference Asset Performance

Early in each calendar year, issuers of structured notes and structured CDs often revisit the question, "how many years of historical information for the reference asset should we set forth in our offering documents?" That is, with the recent completion of the prior year, and the ability to extend all "stub" performance information through December 31st of that year, should one or more older years be deleted from the offering document?

"Black Letter Law"

At least as to common stocks, the SEC's 1996 "Morgan Stanley letter" [3] implicitly requires only two complete years of historical information, together with information for any competed quarters. This is because the letter refers to the requirement for a prospectus to include: "Information concerning the market price of the [Underlying Securities] similar to that called for by Item 201(a) of Regulation S-K." In turn, Item 201(a) of Regulation S-K requires the presentation of historical stock information:

"for the two most recent fiscal years and any subsequent interim period for which financial statements are included, or are required to be included by Article 3-01 through 3-04 of Regulation S-X (§ 210.3-01 through 3-04 of this chapter), or Article 8-02 through 8-03 of Regulation S-X (§ 210.8-02 through 8-03 of this chapter) in the case of smaller reporting companies, as reported in the consolidated transaction reporting system or, if not so reported, as reported on the principal exchange market for such equity."

Different Practices

Of course, readers of structured note offering documents will quickly note that most documents show more than this minimum requirement. However, the specific number of years set forth often varies among different market participants. For example:

- some will seek to show a fixed ten-year period;
- some will seek to show performance since the beginning of 2008, in order to capture the negative impact (on many market measures, at least) of the 2008 fiscal crisis.
- some will seek to show a specified number of years (greater than two full, and the current "stub" period).

[3] Available at the following link: http://media.mofo.com/files/Uploads/Images/Morgan-Stanley-6-24-1996.pdf

Some underlying assets, including some types of proprietary indices, will have more interesting performance histories in some periods, and in some market conditions, than in others. (They may have been designed for that purpose.) Accordingly, issuers that link to these market measures may be interested in showing a period of time that reflects the performance in these different market environments, and the number of years selected may be designed to reflect these differences. (Of course, "cherry picking" only the periods of positive performance would be problematic under all applicable regulatory standards.)

All this being said, particularly for widely available, broad-based equity indices and ETFs, and for large-capitalization stocks, the specific number of years shown above the minimum is not mandated by any particular legal requirement. And we previously discussed,[4] the Morgan Stanley letter's requirements were imposed long before retail investors had easy access to historical index information through the Internet. Today's issuers can have a modicum of confidence that investors who are interested in obtaining this form of information for periods beyond those presented in the prospectus will be able to find them without too much difficulty. Of course, the length of the period discussed in the Morgan Stanley letter should be satisfied or exceeded in all cases.

Tax Developments for Structured Products

Of Q4's federal tax developments, one is already appearing regularly on structured products, and another provides taxpayers with an idea of how the IRS thinks basket option contracts fitting within two October 2015 notices should be treated for federal income tax purposes.[5] A brief summary of each follows.

Extension of New Dividend Equivalent Rules

In September 2015, the IRS issued new final and temporary Treasury regulations under Internal Revenue Code Section 871(m) that cover dividend equivalent payments to nonresident aliens.[6] Generally, the rules treat "dividend equivalents" paid under certain notional principal contracts and equity-linked instruments as U.S. source dividends; accordingly, they are subject to U.S. withholding tax if paid to a non-U.S. person. The initial release of the rules had an effective date that was graduated over 2015, 2016 and 2017. Contracts entered into in 2015 were exempt from the rules, contracts issued in 2016 were only subject to the rules if the contracts made payments in 2018 or onwards, and all contracts issued in 2017 were captured. The concern among issuers of financial contracts was that the short period between September and January 1, 2016 was not enough time to put in place the needed infrastructure to comply with the recordkeeping, determination and withholding requirements under the regulations.

On December 7, 2015, the Internal Revenue Service issued an amendment to the new dividend equivalent regulations to change this effective date.[7] Now, the dividend equivalent regulations will only apply to any payment made on or after January 1, 2017, for any transaction issued on or after January 1, 2017. Thanks to the extension, issuers will have the full 2016 calendar year to develop the architecture that is needed to meet the requirements of the new regime.

IRS Ruling Describes How to Account for Notice 2015-73 and Notice 2015-74 Basket Option Contracts

On October 21, 2015, the IRS issued Notice 2015-73 and Notice 2015-74. These Notices revoked Notice 2015-47 and Notice 2015-48, respectively, and replaced them with new guidance.[8] In addition to releasing the revised Notices, in November, the IRS released CCA 201547004, which elucidates the IRS's view on how basket option contracts that fit within the Notices should be treated for federal income tax purposes.

[4] See our June 25, 2014 edition of this publication, available at: http://www.mofo.com/~/media/Files/Newsletter/140625StructuredThoughts.pdf
[5] For a more detailed discussion of these and other Q4 federal tax law developments, please see MoFo's latest issue of *Tax Talk*, available at http://www.mofo.com/~/media/Files/Newsletter/2016/02/160201TaxTalk.pdf.
[6] For a more detailed discussion of the new regulations, see our Client Alert, available at http://www.mofo.com/~/media/Files/ClientAlert/2015/09/150921DividendEquivalent.pdf.
[7] The published amendment also makes some immaterial edits in other places in the rules.
[8] For a more detailed discussion of the Notice 2015-73 and Notice 2015-74, see the November issue of *Tax Talk*, available at http://www.mofo.com/~/media/Files/Newsletter/2015/11/151103TaxTalk.pdf.

There, the taxpayer purchased two options on a basket of hedge fund limited partnership interests from a bank, which the taxpayer's designee could and did change over the life of the options. Consistent with the basket notices, the IRS concluded that the contracts did not constitute options because they did not function or have the economic characteristics of options. Since the contracts were not options, the IRS explained two different treatments for them. First, to the extent the bank held the referenced assets on the taxpayer's behalf (including as a hedge for the options), the option contracts transferred ownership of the referenced assets to the taxpayer for tax purposes. Second, if the taxpayer could not be considered the owner of the referenced assets for tax purposes (for example, if the bank did not hold the limited partnership interests as a hedge) and the referenced asset was a passthrough entity, then the taxpayer would be subject to the constructive ownership provisions of Code Section 1260 with respect to the referenced asset. Additionally, the IRS stated that where the taxpayer has the discretion to change a basket and exercises that discretion, changes in the referenced basket could constitute a fundamental change in the option and result in a taxable deemed exchange for the taxpayer of the old options for new options.

If taxpayers choose to file amended returns pursuant to the new Notices for basket option contracts they have already entered into, CCA 201547004 provides a roadmap on how to treat those transactions.

The Structured Products Association's Comment Response Letter to the Federal Reserve Board Regarding TLAC and Structured Notes

As discussed in an earlier article in this publication, on October 30, 2015, the Federal Reserve Board ("FRB") issued its notice of proposed rulemaking relating to U.S. bank holding companies which are G-SIBs and the intermediate holding companies of foreign banking organizations that are G-SIBs. Among other things, U.S. G-SIBs will be required to maintain a minimum amount of unsecured long-term debt and a minimum about of total loss-absorbing capital ("TLAC").[9]

In response to the FRB's invitation for comments on the proposed TLAC rule, the Structured Products Association ("SPA") posted a comment response letter.[10] The SPA letter responds to the following aspects of the proposed rule:

- Clarification that certain rate-linked notes and non-USD denominated instruments are excluded from the definition of "structured note" (and, consequently, would be eligible debt securities);
- Clarification that debt securities linked to readily ascertainable reference rates are eligible debt securities;
- A proposal to add a "default amount" provision to structured notes, causing their value to be readily ascertainable upon an acceleration after an event of default; and
- A discussion of the 5% cap on the value of a covered bank holding company's eligible external TLAC for certain non-contingent liabilities to third parties that are not otherwise eligible debt securities. Structured notes that are not considered eligible long-term debt are subject to the 5% cap. The SPA letter questions the rationale behind this exclusion.

The deadline for submitting comment response letters to the FRB was recently extended from February 1, 2016 to February 16, 2016.

[9] Structured Thoughts, Vol. 6, Issue No. 7 (Nov. 4, 2015), available at http://www.mofo.com/~/media/Files/Newsletter/2015/11/151104StructuredThoughts.pdf.
[10] The SPA letter is available at http://www.federalreserve.gov/SECRS/2016/February/20160208/R-1523/R-1523_020516_130203_487725025622_1.pdf.

Upcoming Events

Masterclass: Structured Alternatives to Structured Notes
Tuesday, February 23, 2016

Morrison & Foerster Partner Anna T. Pinedo will discuss the issuance of structured notes from bank holding company subsidiaries that are finance companies, the issuance of structured notes through a repackaging vehicle and the disclosure and reporting requirements entailed in a bond repackaging, as well as potential Volcker Rule considerations, the issuance of custodial receipts, and the use of unit investment trusts.

For more information about this complementary CLE seminar, or to register, click here.

Current Practices and Issues for Foreign Broker-Dealers Under Rule 15a-6 in 2016
Wednesday, March 30, 2016

Morrison & Foerster Senior Of Counsel Hillel T. Cohn will present on current practices and issues for foreign broker-dealers under Rule 15a-6. This session will cover topics including: Summary of Rule 15a-6 requirements; Risks and responsibilities of acting as a chaperoning broker; Practical issues in intermediating Rule 144A and other transactions; Benefits of an intermediary agreement; and Dealing with retail customers under Rule 15a-6.

For more information about this complementary CLE teleconference, or to register, click here.

Announcing our *Structured Thoughts* LinkedIn Group

Morrison & Foerster has created a LinkedIn group, *StructuredThoughts.* The group will serve as a central resource for all things Structured Thoughts. We have posted back issues of the newsletter and, from time to time, will be disseminating news updates through the group.

To join our LinkedIn group, please click here and request to join or simply e-mail Carlos Juarez at cjuarez@mofo.com.

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Morrison & Foerster has been shortlisted for the 2016 Equity Derivatives Law Firm of the Year for the *EQDerivatives* Global Equity & Volatility Derivatives Awards. 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*.

About Morrison & Foerster

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.