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Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

UK's FCA Restricts Marketing of Unregulated Collective Investment Schemes and Similar Products to Retail Investors

Following a public consultation conducted by its predecessor, the Financial Services Authority (FSA), the Financial Conduct Authority (FCA) of the UK has published new, final rules[1] restricting the distribution of unregulated collective investment schemes and "close substitutes" to certain retail investors.

Unregulated collective investment schemes (UCIS) are collective investment schemes (as defined in Section 235 of the Financial Services and Markets Act 2000), the operator of which has not applied for or obtained authorised or recognised scheme status from the FCA. These CIS are not generally subject to the FCA rules on the operation of collective investment schemes, such as in relation to a CIS' investment and borrowing powers, its management of risk, information to investors and provisions regarding fees and other investor protection measures.

In addition to UCIS, the new rules focus also on schemes that the FCA regards as close substitutes to UCIS and that, together with UCIS, it terms "non-mainstream pooled investments" (NMPIs). Expressly within the scope of the NMPI definition are units in qualified investor schemes (QIS), non-excluded securities issued by special purpose vehicles (SPVs) and traded life policy investments (TLPIs).

Background. The FSA had previously concluded that most retail promotions and sales of UCIS that they had reviewed were inappropriate and exposed ordinary retail investors to significant risk of detriment. The rules are intended to

[1] Appendix 1 to Policy Statement 13/3 of the Financial Conduct Authority, http://www.fca.org.uk/static/documents/policy-statements/ps13-03.pdf.

Attorney Advertising

enhance consumer protection by restricting the promotion of NMPIs to those consumers for whom these products are likely to be unsuitable.

Ban on marketing NMPIs to certain investors. The FCA distinguishes between three different types of retail investor: sophisticated investors, high net worth individuals and "other retail investors." The FCA's rules are designed to protect the "other retail investors," who are the vast majority of the UK retail market, by a complete ban on promoting NMPIs to them, except in very limited circumstances.

Beginning 1 January 2014, firms must comply with this new communications ban. The means that a firm must not communicate or approve an invitation or inducement to participate in, acquire or underwrite a non-mainstream pooled investment when that communication is likely to be received by a retail client, unless the relevant promotion falls within one of a number of exemptions, such as a promotion to a sophisticated investor or to a high net worth individual.

The FCA is particularly concerned about a number of different investment types, including traded life policy investments (investments in second-hand life insurance policies of US citizens—sometimes known as traded life settlements or senior life settlements). The FCA has found these TLPIs to be "higher risk, complex and opaque products, yet often marketed as low risk on the basis of being uncorrelated with mainstream investments, and many of these products have failed and caused significant consumer detriment." Also of concern to the FCA are schemes based on investments in land, overseas forestry and crops, property/hotel developments and wine.

The FSA's consultation paper made clear that, despite the reference to securities issued by SPVs, structured products were not the focus of its intervention action. However, since the FSA had encountered securities issued by SPVs that were used to facilitate retail investment in TLPIs, the FCA's final rules provide that securities issued by SPVs should not automatically be excluded from the definition of NMPI. When the SPV invests in non-mainstream assets, it could be subject to the NMPI restrictions.

Therefore the final rules generally include securities issued by an SPV in the restrictions, subject to a list of exclusions. Among other things, covered bonds, investment trusts, venture capital trusts and REITs and exchange traded products are excluded. Also excluded are securities "wholly or predominantly linked to, contingent on, highly sensitive to or dependent on, the performance of or changes in the value of shares, debentures or government and public securities, whether or not such performance or changes in value are measured directly or via a market index or indices, and provided the relevant shares and debentures are not themselves issued by SPVs."

Of particular interest to US persons resident in the UK: funds registered under the US Investment Company Act of 1940 are excluded from the prohibition. That is, broker-dealers may promote US registered investment companies in the UK to any person who is classified as a United States person for tax purposes under US legislation, or who owns a US qualified retirement plan. This exemption was crafted by the FCA in response to comments that, in the case of US citizens temporarily resident in the UK and expecting to return to the USA, regulated US mutual funds are likely to be more suitable than EEA-regulated funds, and therefore should not be subject to marketing restrictions to which the EEA funds were not.

The FCA has also provided further guidance to firms wishing to rely on the exemptions for promotions to certified high net worth investors, self-certified sophisticated investors and for non-recognised UCITs (*i.e.* funds which have been approved by an EEA regulator in accordance with the UCITS legislation, but where the fund manager has not applied for the fund to be recognised in the UK). It notes that a preliminary assessment of suitability is required before the promotion of NMPIs to clients, although this preliminary assessment does not extend to a full suitability assessment, unless the NMPI is being promoted on an advised basis. However, it states that the preliminary assessment of suitability requires the firm to take reasonable steps to acquaint itself with the client's profile and objectives in order to ascertain whether the particular NMPI is likely to be suitable for that client.

One more item of interest in the FCA's policy statement that contained the final rules is an indication that the FCA is planning to consult on other possible new marketing restrictions. In particular, it is concerned that the new Basel III and (in Europe) CRD4 requirements for banks and building societies to raise loss-absorbing capital will lead to firms offering these types of regulatory capital instruments, and similar instruments such as contingent capital securities (CoCos), to retail consumers who do not have the necessary experience and understanding to evaluate them. It therefore plans to consult on a new restriction for the marketing of these products only to sophisticated or high net worth retail investors, as well as professional investors. In the meantime, it expects issuers to distribute these sorts of instruments in a way that prevents ordinary retail investors from buying them, and it does not rule out using its temporary product intervention powers[2] to address these risks in the short term if necessary.

Also on the FCA's radar are the criteria used to determine when a retail client qualifies as a "high net worth individual." Currently the criteria are that the person must have an annual income of more than £100,000 or investable net assets of £250,000. These criteria were determined back in 2001, and the FCA plans to consult on whether they are still set at an appropriate level, or whether they should be raised.

Electronic Structured Note Systems and U.S. Securities Regulation

Introduction

Market participants in a number of jurisdictions outside of the U.S. use different types of electronic systems to offer structured products. In these countries, brokers and investment advisers use these types of programs to show investors the pricing and terms for different types of offerings. In some cases, the systems can also be used to effect actual sales.

The features of current systems, and any future systems, may vary. Depending upon the service in question, it may:

- show investors the current trading values of previously issued structured notes, with or without enabling investors to purchase them; or

- show investors a broker's current offerings, again with an opportunity to place an order for the product.

More elaborate systems could show the investor the potential pricing of a newly-issued product with different parameters. For example, imagine a simple structured note linked to a particular stock, which provides a buffer against losses on the downside, together with a multiple of the participation in the upside, subject to a cap. In such a system, if, for example, the investor sought to increase the upside participation rate, the system would show the extent to which the cap on the upside may decrease, or the buffer on the downside may decrease.[3] Such a system could show investors preliminary terms that could be accepted within a specified period of time, possibly by entering an order on the system. Depending on the capabilities of such a system, the system may automatically generate final term sheets and simple final pricing supplements.

In this article, we examine the federal securities regulations that would apply to systems of this nature if used in the U.S., and describe a number of other related practical issues to address in the U.S. market.[4]

Prospectuses and Free Writing Prospectuses

User Interface/Website. In the case of registered structured notes, the system interface itself would likely be deemed a "free writing prospectus" under the SEC rules. Accordingly, depending on its use, and which securities were offered on it, the relevant screens viewed by investors may be required to be filed with the SEC under Rule 433 by one or more of the relevant issuers, and/or the broker-dealer that operated the system. Depending on its use, and which party files it with the SEC, the document may also be subject to filing with FINRA under Rule 2210(c)(3)(E).

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[2] See Morrison & Foerster's Structured Thoughts Vol. 4 Issue 5, "FCA Temporary Product Intervention Rules: Nipping It In The Bud", http://www.mofo.com/files/Uploads/Images/130412-Structured-Thoughts.pdf.
[3] Because there is no such thing as a free lunch.
[4] Many brokers maintain internal pricing systems, which they use to help set the terms for structured products. These systems are not accessed directly by the investor, and we do not address them in this article.

Product Supplements. In the case of registered structured notes, a robust prospectus should be made available to the investor prior to the investor's investment decision. In the case of an electronic system, this would likely be accomplished through a hyperlink on the website to a "product supplement" or similar document that describes the key terms and risks of the relevant product in which the investor sought to invest. The system could also have functionality to e-mail a .pdf version of that document to the investor. That document, together with the issuer's base prospectus and any "MTN prospectus supplement," would typically be filed with the SEC prior to its use under Rule 424(b).

Brokers would likely want to ensure not only that investors had access to this key document, but also that the investor has an appropriate amount of time in which to read it. Accordingly, a system may operate such that, for an investor that has not recently purchased a similar product, the investor's agreement to purchase the product could only be entered following the passage of a certain amount of time after these documents had been made available to the investor.

Preliminary Term Sheets. In the case of a system that enables an investor to customize a product around certain parameters, the system would produce preliminary term sheets that set forth to the investor the potential terms of the offering, which would only be available for purchase during a particular period of time. After that period, the pricing and economic terms of that instrument may change, due to changes in market conditions. Such a term sheet would typically constitute a free writing prospectus, which would be required to contain the legend required by SEC Rule 433. However, such documents would not be required filings on the EDGAR system, under Rule 433(d)(5)(i), since they are preliminary in nature. (This feature would avoid the need to publicly file the preliminary term sheet for every iteration of the structure requested to be viewed by the investor, the majority of which did not result in an actual sale.[5]) In addition, since these documents are customized for each individual investor, and not broadly disseminated, they would not constitute "retail communications" under the FINRA Rule 2210(a)(5). Instead, they would typically constitute "correspondence" under FINRA Rule 2210(a)(2).

A new challenge for issuers: under the SEC's recent guidance, the estimated value of the notes, or a range of estimated values, needs to be provided to the investor before it makes an investment decision. That information could be set forth in the preliminary term sheet presented by the system. However, in order to do so, the operator of the system would have to ensure that the system is capable of accurately employing its pricing models on a rapid basis so as to properly include this information.

Pricing and Final Pricing Supplements. For an investor that elects to act on a set of offering terms, and decides to purchase the product, a system of this kind may generate a final pricing supplement (and perhaps a final term sheet) in a specified form. Such a final pricing supplement must be filed with the SEC under Rule 424(b) within two days of the agreement. Similarly, a final term sheet would be filed with the SEC under Rule 433 on the same timeframe. The broker-dealer may seek to act on the "access equals delivery" model established under SEC Rules 172 and Rule 173. Using these rules, by filing the final pricing supplement and entering an appropriate note on the investor's purchase confirmation, the broker would avoid the need to print a copy of the issuer's full suite of offering documents: base prospectus, MTN prospectus, product supplement and final pricing supplement.

Exempt Offerings and Private Placements. Needless to say, the above paragraphs assume that, like for most structured notes, the issuer is effecting the sales using a shelf registration statement. But that need not be the case. Issuers could consider establishing systems that offer exempt bank notes or bank certificates of deposit, or even that are limited to private placements. These types of offerings are outside the scope of the Rule 424(b) filing requirements and the rules relating to free writing prospectuses.[6] A Regulation D private placement system, in which the notes may only be sold to "accredited investors," may seem appealing, in that it would avoid any SEC filing requirements (other than a notice filing on Form D), and perhaps avoid the SEC's insistence on the inclusion of estimated value disclosures. A private system may also be used to help support the "suitability" analysis discussed below. However, such a program would need to be carefully vetted, for example, to ensure that the private offerings would not be integrated with the issuer's registered offerings of similar structured securities.[7]

[5] For example, in a service like the one described above that enables an investor to vary one or more terms, the investor may review multiple versions of the same product, with different economic parameters.
[6] Depending upon the context, these offerings are subject to relevant securities or banking anti-fraud or truth-in-disclosure rules.
[7] Under the 2012 "JOBS Act," the SEC is required to adopt rules that will liberalize to some extent the degree of permitted communications in Regulation D offerings.

FINRA Issues

FINRA Communications Rules. FINRA rules and guidance would need to be considered in connection with the establishment of an electronic system. Among other things, the materials and interface prepared by any broker for such a system could be subject to the approval, content and filing provisions of FINRA Rule 2210. In light of FINRA's ongoing concerns relating to structured products, it may be difficult to implement a system through which retail investors may make purchases, without some sort of direct advice from a registered representative during the process.

Recommendations and Suitability. To the extent that any offer under the system is deemed a "recommendation," which it could be in the case of a retail investor, a variety of FINRA provisions would apply, including FINRA's rules relating to reasonable basis suitability and customer-specific suitability.

FINRA Notice 11-02[8] describes FINRA's considerations for determining whether a recommendation has occurred, applying a "facts and circumstances" test. A system in which investors made their own independent decisions as to whether to purchase a product, or how to customize a product, would not appear to be a "recommendation" of a security. However, to the extent that a broker is setting the parameters for the products that may be purchased, and advertising the flexibility of such a system, there may be a question as to whether some sort of "recommendation" occurs at the time of sale. FINRA may have concerns that individual investors do not have the ability to properly evaluate these parameters and options without professional advice.

Accordingly, in connection with a system of this kind, a variety of steps could be taken to bolster the analysis. For example:

- The system could inform investors explicitly that the products sold on the system are not recommended for any and all investors.
- The system could require that investors seek the specific advice of their financial advisors before making an investment decision.
- The system could be limited to investors that satisfy specified parameters, such as institutional investors or those who satisfy a wealth test, or that have a given number of years of investing in structured products.
- A system that permitted investors to select different parameters for an investment, such as buffer levels, caps and participation rates, should vet the potential outputs with a "reasonable basis" analysis in mind.[9] That is, can the various types of securities generated by the system be justified as suitable to at least some investors, based on their potential risks and rewards?

In short, creating a system that leaves product design all or partially in the hands of individual investors creates significant challenges in light of FINRA's recent concerns.

Practice Pointers

In a service that enables investors to price and purchase new series of structured notes, a variety of additional practical considerations would also need to be addressed:

- Creating a system for obtaining and assigning CUSIP/ISIN numbers for the securities.
- Ensuring that the documents were converted to an EDGAR format, and filed with the SEC, on a timely basis.

[8] Available at: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf.
[9] This type of functionality may require that all investors be institutional investors, due to the ability to create products viewed by FINRA as "complex," and thus potentially not suitable for retail investors.

- Ensuring that counsel had the opportunity to pass on the forms of the relevant documents to ensure that any required corporate and tax opinions can be rendered (and if needed, filed with the SEC) on a timely basis.[10]
- Ensuring that the securities are made DTC eligible.
- Ensuring that TRACE reports are filed on a timely basis.
- Ensuring that all necessary closing documents, forms and global notes, and other relevant documents are prepared.

Conclusion

Electronic systems potentially offer U.S. market participants a variety of desirable features and opportunities. However, these systems must be carefully planned in order to conform to the legal requirements of the U.S. market.

Reminders from the SEC and FINRA

On June 12, 2013, Celia Moore, Assistant Director of the SEC's Structured New Products Unit, Division of Enforcement, and Richard Vagnoni, Senior Economist of FINRA, spoke in a panel at the annual North American Structured Products Conference. The title of the panel discussion was: "Regulators Panel: What Are the Responsibilities of the Issuer and the Distributor?" The panel was organized to address continuing questions that arise in the structured products market as to the proper allocation of legal responsibilities among offering participants.

The speakers used the opportunity to provide some useful reminders about how the SEC and FINRA have analyzed a variety of issues, and the approach they take in regulating the market.

Continuing SEC Attention. First, Ms. Moore noted that structured products remain a significant focus of attention for the SEC. The SEC has established structured product working groups within the Office of Compliance Inspections and Examinations (OCIE), as well as in its recently renamed Division of Economic and Risk Analysis. These divisions are additional to the relatively new Office of Capital Markets Trends, which has significantly focused on this market. These divisions, together with other personnel from the Division of Corporate Finance and the Enforcement Division, communicate with one another in order to monitor market developments.

Know Your Distributor. Both speakers encouraged issuers and underwriters alike to take appropriate means to ensure the quality and experience of their distributors for structured products. In particular, appropriate review should be made of distributors who may be new to structured products.

Responsibility of Underwriters and Issuers for Downstream Distribution. Ms. Moore suggested that a party, such as an issuer, could not absolve itself entirely from an inappropriate sale by a downstream distributor, simply because that distributor was the entity which made the sale to the actual investor, and had a duty to make a suitability determination. Although many of the most important suitability determinations will rest upon such a downstream distributor, other parties to the transaction are likely to have duties as well. Ms. Moore pointed to the 2006 Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities.[11] This statement sets forth a variety of recommended practices for issuers and product manufacturers to take, whether or not they are making sales of the product to a customer. These duties include, for example, adopting appropriate approval and review procedures. And of course, inappropriate sales by third-party distributors can create significant reputational risks for the issuer.

Areas of Regulatory Focus. Both speakers identified a few common themes as to areas and practice that are more likely to attract regulatory scrutiny:

[10] See the SEC's Staff Bulletin No. 19: http://www.sec.gov/interps/legal/cfslb19.htm.
[11] The statement may be found at: http://www.sec.gov/rules/policy/2006/34-53773.pdf.

- Products and disclosure documents involving complexity, opacity or ambiguities that might make it easier to perpetuate fraud.
- Products characterized by a lack of liquidity.
- Products involving conflicts of interest.

Ease of Access. The panelists noted that many complex products were becoming more available to retail investors, including through self-directed accounts. Some brokers have been more willing than others to enable these types of accounts to elect to purchase these types of investments. Ms. Moore noted that in these situations, additional caution was recommended to ensure that appropriate disclosures of risks were provided to the relevant investors, in order to help strengthen their ability to make better investment decisions.

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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 in the Americas, 2012, 2013 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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