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Structured Thoughts

News for the financial services community.

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European Product Intervention

Under Article 40 of the European Markets in Financial Instruments Regulation (MiFIR), published earlier in 2014, the European Securities and Markets Authority (ESMA) was given powers to temporarily prohibit or restrict the marketing, distribution or sale of certain financial instruments, or financial instruments with certain specified features, or any type of financial activity or practice, in each case subject to the satisfaction of certain conditions.

Extremely similar powers are given to the European Banking Authority (EBA) in respect of structured deposits. A structured deposit is defined as a deposit whose principal balance is repayable at par at maturity, on terms under which interest or premium on the deposit is dependent upon the performance or value of an underlying such as an index, a financial instrument, a commodity or a foreign exchange rate. Structured deposits have been bought within the scope of the MiFID regime for the first time by MiFIR, pursuant to the PRIPS initiative to harmonise the regulation of financial investments having similar economic effects.

Similar powers are also given to national competent authorities of EU member states, in relation to both financial instruments and structured deposits, subject to the same conditions as well as further safeguards.

Of the conditions to be met, in each of the above cases, the most important is that the proposed action should address a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the whole or part of the EU financial system.

In connection with these temporary intervention powers, the European Commission is empowered to adopt delegated acts that specify the criteria and factors to be taken into account in determining when there is such an investor protection concern or threat to the operation or stability of markets or the financial system. Therefore, the European Commission has requested ESMA to provide technical advice in this regard in relation to the financial markets or commodity markets, and similarly has requested such technical advice from the EBA in relation to structured deposits. As a precursor to its technical advice, ESMA launched a consultation in May 2014, setting out its proposals as to such criteria and factors. The EBA chose to wait until ESMA's consultation had closed before launching its equivalent consultation paper in relation to structured deposits on 5 August 2014.

FINRA Speaks at 2014 Structured Retail Products Conference

On June 26 and 27, *Structured Retail Products* hosted its annual industry conference in Boston. The remarks of two FINRA officials provide a useful update of FINRA's views as to a number of issues affecting the industry.

Product Complexity

On June 26, Tom Selman, FINRA's Executive Vice President, Regulatory Policy and Legal Compliance Officer, was interviewed at the conference about current issues. He referenced FINRA's Regulatory Notice 12-03 on complex products[1] as a useful compendium of FINRA's guidance on the subject, which guidance remains valid today. Although the release did not provide a definition of "complex" that could be easily applied to all products, Mr. Selman encouraged industry participants to err on the side of viewing a product as potentially complex; he urged product manufacturers not only to consider product development under FINRA's rule-making policy and public statements, but also to consider how they would be viewed in the context of potential arbitration proceedings with unhappy customers, and to view them from the perspective of an entity with a fiduciary duty to its customers. According to Mr. Selman, FINRA has no current plans to issue an update to 12-03.

Examinations

Mr. Selman discussed FINRA's examination process. He noted that the mere fact that a firm was offering structured products would not, in and of itself, increase the likelihood that the firm would be subject to an examination in any particular year.[2] He also noted that the findings of FINRA's 2013 report on conflicts of interest[3] have been integrated into the exam process, and that brokers should expect the report's findings and conclusions to be addressed during the exam process.

Recent FCA Action

Mr. Selman discussed the UK Financial Conduct Authority's recent fines imposed based upon a principal protected cliquet product.[4] He observed that some of the pertinent facts could raise issues under the FINRA rules as well:

- Excessively prominent disclosure of a maximum return that is highly unlikely, or impossible, to achieve.
- A product with a very limited chance to generate a return in excess of its minimum return could be scrutinized under FINRA's reasonable basis suitability rules.

[1] Available at: https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125397.pdf.
[2] Several sighs of relief were heard in the room at that point.
[3] Available at: http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf.
[4] We discuss that case in our June 2014 edition of *Structured Thoughts*: http://www.mofo.com/~/media/Files/Newsletter/140625StructuredThoughts.pdf.

Communications Rules

On Friday, June 26, Amy Sochard, FINRA's Senior Director, Advertising Regulation, spoke as part of a regulatory panel. She noted that approximately 60 members of FINRA's advertising staff are involved in the day-to-day review of materials, including a dedicated team focused on structured materials. This year, FINRA advertising will review approximately 100,000 items overall.

FINRA has reviewed more than 1,200 filings that were affected under the new rules that related to structured products. These materials include product brochures and structured product websites. (There have been few, if any, conventional "advertisements" for this asset class.) Mr. Selman indicated that FINRA provided comments on 75% of these filings, and that, perhaps alarmingly, in 50% of these comments, FINRA requested that the relevant broker not use those materials further.

Mr. Selman indicated that the following types of communications had raised the most significant issues:

- Blast emails relating to structured products that did not provide the necessary disclosures as to the risks of a product, or even its structure.
- Materials relating to ETN performance: these materials improperly showed the performance of the underlying index or benchmark, instead of showing the relevant exchange-quoted prices for the ETN itself.

Among FINRA's more regularly recurring comments on structured products materials generally were:

- Not disclosing that the particular product is not suitable for all investors.
- Not disclosing the possibility of loss of principal.
- Not disclosing product fees and expenses.
- Overstating the liquidity of a product.
- Improperly disclosing to investors that a product's performance will be "steady" or "stable."
- Improperly using back-tested performance information in retail marketing products.[5]
- Improperly implying that investments are safe.
- Improperly glossing over the risks of a product or its complexity.

Notwithstanding these issues, and the high rate of rejection of proposed materials, FINRA believes that the quality of these materials generally is improving.

Ms. Sochard confirmed FINRA's position that broker-dealers need not file structured product "free writing prospectuses" that are exempt from filing under SEC Rule 433. On June 26, the SEC approved FINRA's advertising rule amendments that clarify this position.[6]

In general, FINRA expects to need four to six weeks to review materials that are submitted to it. That timing is expected to improve over time as the quality of materials continues to improve. FINRA employs an expedited process for review of

[5] A discussion of FINRA's position relating to the disclosure of back-tested information may be found at the following link: http://media.mofo.com/files/Uploads/Images/130426-Structured-Thoughts.pdf.
[6] The SEC's order may be found at the following link: http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p544261.pdf.

materials that involve only modest changes to materials that have been previously removed. Ms. Sochard stated that if there are materials that require immediate attention, the broker can phone the advertising department to discuss, and the department will attempt to accommodate that request. If a broker is planning to use new forms of communication, Ms. Sochard encouraged the broker to consider phoning the department prior to the submission in order to discuss.

FINRA Approves Amendments to Communication Rules – Relief from Filing for Certain FWPs

On July 11, 2014, FINRA announced the immediate effectiveness of its amendments to its communication rules.[7] Among other items, the amendments relate to the filing and content requirements for retail communications relating to structured products.[8]

Filing Requirements

Rule 2210, as amended effective February 2013, requires broker-dealers to file with FINRA "retail communications" concerning registered structured products. Rule 2210(c)(7)(F) exempted from this requirement prospectuses, preliminary prospectuses, offering circulars and similar documents that are filed by the issuer with the SEC.

Many market participants found Rule 2210's filing requirements somewhat ambiguous as to the filing requirements for free writing prospectuses (FWPs) that are exempt from filing with the SEC under Rule 433. The most widely used of these types of documents are preliminary (or summary) "term sheets," which are often provided to investors along with the longer red herring; these documents were typically not filed with the SEC, due to Rule 433(d)(5)(i). Since they were not filed with the SEC, they appeared to require filing with FINRA under the text of the rule. As a result, many brokers began to file these types of documents with FINRA; alternatively, a variety of issuers began to file them with the SEC, notwithstanding the exemption from Rule 433's filing requirement, in order to benefit from the exemption from FINRA filing under Rule 2210(c)(7)(F).

Under the amendments, the exclusions from its filing requirements will cover both prospectuses filed with the SEC and FWPs that are exempt from filing. However, the rules will continue to require broker-dealers to file FWPs with FINRA that are filed with the SEC under Rule 433(d)(1)(ii)—this provision applies to underwriter FWPs that are made available on a broad unrestricted basis, such as a website.

Content Requirements

In addition, the amendments clarify that an FWP that is exempt from filing with the SEC under Rule 433 is not subject to FINRA's content standards. However, we do not expect FWP disclosures to change significantly as a result of this clarification. These documents, if they contain material misstatements or omissions, can still result in liability under the federal securities laws. Accordingly, market participants will continue to carefully review their content, and whether they are appropriate for the target audience.

FINRA Review

At June 2014's Structured Retail Conference in Boston, FINRA representatives noted that FINRA has reviewed more than 1,200 filings that were affected under the new rules that related to structured products. Many of these were preliminary term sheets, filed with FINRA due to the uncertainties noted above. (Many of these filings also may have been somewhat

[7] FINRA's notice announcing the effectiveness, as well as the text of the amendments, may be found at the following link: https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p550865.pdf.

[8] The amendments also exclude from the filing requirements research reports that relate only to securities listed on a national securities exchange. The amendments also address a mistaken cross-reference in FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools).

repetitive, as they could relate to similar offerings that were made on a weekly or monthly basis.) As a result of the FINRA comment process, many market participants have had an opportunity to learn more about FINRA's views as to structured product disclosures and to make a variety of revisions to their documents to address these views.

Investment Funds and Structured Products

In a July 14, 2014 speech (http://www.sec.gov/News/Speech/Detail/Speech/1370542253660), Norm Champ, the Director of the SEC's Division of Investment Management, addressed issues of concern to issuers of structured products. Among other things, he emphasized that the SEC staff is concerned about misleading fund names and the adequacy of disclosures about use of derivatives and leverage. While his remarks did not necessarily break new ground, they served as a useful reminder that structured products are not immune from the Division's concerns and potential compliance issues.

Fund Names

Mr. Champ summarized the Division's November 2013 guidance concerning misleading fund names. Mr. Champ said that the staff's examination process found that several funds had names that suggested safety or protection from loss, and requested that those funds change their names so that they were not misleading. He summarized past guidance in which the staff has encouraged funds to reevaluate their names and, if appropriate, change the name to eliminate the potential for investor misunderstanding; this might especially be the case when the funds expose investors to market, credit, or other risks but the fund's name suggests safety or protection from loss.

Use of Derivatives and Leverage

Mr. Champ summarized staff guidance on use of derivatives and leverage by funds. To date, the staff has taken a somewhat piecemeal approach to the regulation of derivatives and leverage; in August 2011, it published a concept release that identified a number of issues of concern to the SEC, including the adequacy of disclosure and misuse of leverage.

Most recently, the staff published guidance that reminded funds of their responsibility to clearly disclose the risks of derivatives, including funds that underlie variable annuity contracts:

- Funds that intend to use derivative instruments should assess the accuracy and completeness of their disclosure, including whether the disclosure is presented in an understandable manner using plain English.
- Any investment strategy disclosure related to derivatives should be tailored specifically to how a fund expects to be managed, and should address those strategies that the fund expects to be the most important means of achieving its objectives and that it anticipates will have a significant effect on its performance.
- The disclosures also should describe the purpose that the derivatives are intended to serve in the portfolio—hedging, speculation, or as a substitute for investing in conventional securities.

Because investment strategies that employ derivatives may introduce additional risks, the staff expects funds that use derivatives strategies to address those risks in their disclosures. These risks could include, for example, risks relating to volatility, leverage, liquidity, and counterparty creditworthiness that are associated with trading and investments in derivatives that are engaged in by the fund.

New York Court Endorses Structured Note Risk Factors in Class Action Dismissal

In June 2014, the U.S. District Court for the Southern District of New York granted Credit Suisse's motion to dismiss a class action arising out of the Velocity Shares Daily 2x VIX Short Term ETN.[9] As many readers of this publication know, the value of this ETN decreased significantly in 2012 when the issuer temporarily suspended the issuance of new ETNs.

The decision is a useful reminder of the importance of careful drafting of prospectus and pricing supplement risk factors.

The following table identifies some of the plaintiffs' claims, and the relevant prospectus language or analysis that helped to overcome the claims:

Claim	Prospectus Language and Analysis
The offering documents did not clearly warn investors not to hold the ETNs for longer than a single trading session.	25 plain English warnings concerning the risks of holding the ETNs for a longer period.
The offering documents should have spelled out and quantified particular risks associated with the ETNs' daily rebalancing figure, which reduced their return over time.	The offering documents disclosed that there is a significant chance of a complete loss of the value of the ETNs, and that their value would erode over a longer period of time. The court indicated that precise computations were not required.
Some of the information in the prospectus, such as examples of potential positive payouts at maturity, undermined the risk factor advising investors not to hold ETNs for more than one day.	Given the overall mix of information, including the numerous warnings, the court found that a reasonable investor could not have properly understood that it was reasonable to hold the ETNs for more than one day.
The offering documents did not properly disclose the circumstances under which the issuer might cease to issue additional ETNs, or the precise impact on the ETNs' market price that such cessation could have.	The offering documents fully disclosed that the issuer was under no obligation to issue additional ETNs. The issuer disclosed the fact that it could cease to issue at any time, and as a matter of law, it was under no obligation to disclose why new issuances could cease.
The offering documents did not properly disclose that the issuer's "vertical platform," which used affiliates to perform functions such as hedging the ETNs, was riskier than an "open platform" involving non-affiliated entities, and made it more difficult to hedge the issuer's exposure.	The prospectus adequately disclosed in the risk factor section and elsewhere the risks posed by the "vertical platform," and how the activities conducted by the issuer and its affiliates could affect the underlying index and the value of the ETNs.

[9] A copy of the decision may be found at the following link: http://securities.stanford.edu/filings-documents/1049/TVIX00_01/201469_r01x_12CV04191.pdf.

The decision relies to a significant degree on the risk factor disclosures set forth in the prospectus. However, the decision also includes cautionary language that reminds practitioners that there are limits on what risk factors they can reasonably expect to anticipate:

Whatever formula is used to determine an investor's return, to the extent that it relies on future values of an underlying index, which cannot be known in advance, it is not a material omission to fail to predict future market performance.

The liability provisions of the 1933 Act do not require the disclosure of publicly available information, such as historical volatility trends.[10]

Detailed computations are not necessary in order to describe the fundamental risk associated with volatility and daily rebalancing; when the prospectus warns of a risk that later materializes, investors will not have a Section 11 claim.

Once a risk has been properly disclosed, the prospectus is not necessarily required to predict the precise effect that will follow from a manifestation of that risk.

The Southern District's decision is a useful reminder to issuers, underwriters and their lawyers to consider carefully the nature of the risks inherent in the products they are offering and to tailor the disclosures to address them.[11]

[10] By way of contrast, as many readers of this publication know, certain publicly available information is required in a prospectus under the "Morgan Stanley letter." The requirements of that no-action letter differ to some extent from the potential disclosure requirements in order to avoid liability for material omissions under the 1933 Act.

[11] We congratulate our colleagues at Davis, Polk & Wardwell LLP, who represented the defendants in this action.

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

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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