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REVERSE inquiries

Structured and market-linked product news for inquiring minds.

A New ISDA Supplement Provides Some Certainty for SOFR Floating Rate Notes

In This Issue

The International Swaps and Derivatives Association, Inc. ("ISDA") recently published a new supplement to the 2006 ISDA Definitions.[1] Supplement number 57 (the "Supplement") defines a rate for a daily compound interest investment where the reference rate for the interest calculation is the Secured Overnight Financing Rate ("USD-SOFR-COMPOUND"). The Supplement contains a number of useful items that respond to issuers' and the market's need for uniformity:

- a definition of SOFR;
- a precise waterfall of fallbacks if SOFR or its replacement rate is not published or is no longer available; and
- a clear definition of a cessation of SOFR or one of the fallback rates.

In brief, SOFR, for any interest determination date, is the rate published on the website of the Federal Reserve Bank of New York (the "FRBNY") on the next US Government Securities Business Day (the reset date). If SOFR is not so published, then the following fallbacks apply (in summary):

- If SOFR is not published by 5:00 p.m., New York City time, on the reset date and a SOFR Index Cessation Event has not occurred, then SOFR for that reset date will be the rate published on the first preceding US Government Securities Business Day on which the rate was published;
- If a SOFR Index Cessation Event has occurred, then SOFR for the reset date will be the replacement rate recommended by the FRBNY or a committee endorsed or convened by the Board of Governors of the Federal Reserve System and/or the FRBNY;

[1] The Supplement is available for free at: https://goo.gl/9LWu9e.

- If no such replacement rate is recommended within one US Government Securities Business Day of the SOFR Index Cessation Event, then the rate falls back to the daily Overnight Bank Funding Rate (the "OBFR") published on the FRBNY's website;
- If no such replacement rate has been recommended and an OBFR cessation event has occurred, then the rate will fall back to the FOMC Target Rate, which is the short-term rate target set by the Federal Open Market Committee and published on the FRBNY's website.

The definition of "SOFR Index Cessation Event" removes any doubt as to if and when SOFR ceases to be available:

- A public statement by the FRBNY (or any successor) announcing that it has ceased or will cease to provide SOFR permanently or indefinitely, provided that, at that time, there is no successor administrator that will continue to publish SOFR;
- The publication of information that reasonably confirms that the FRBNY (or any successor) has ceased or will cease to provide SOFR permanently or indefinitely, provided that, at that time, there is no successor administrator that will continue to publish SOFR; or
- A public statement by a regulator or other official sector entity prohibiting the use of SOFR that applies to, but need not be limited to, all Swap Transactions, including existing Swap Transactions.

The disclosure documents for several recent SOFR floating rate note issuances closely follow the Supplement.

The Supplement will also be useful to issuers that are updating their LIBOR fallback disclosures. Many issuers have updated those disclosures so that if LIBOR is unavailable, the calculation agent will use an agreed-upon replacement rate, with an appropriate risk spread adjustment and term structure. Issuers may now reference USD-SOFR-COMPOUND as the replacement rate, and continue to make reference to the calculation agent's use of the risk spread adjustment and term structure. The Supplement also addresses some of the issues raised by the Alternative Rates Reference Committee in the committee's voluntary guiding principles for developing new LIBOR fallbacks, in that it is a uniform basis for the use of SOFR as a replacement rate and it also addresses a potential cessation of SOFR.[2]

SEC Chair Clayton Highlights Themes from Retail Investor Roundtables

Since the Securities and Exchange Commission (SEC) proposed Regulation Best Interest in April 2018, it has held a series of "roundtables" and invited retail investors to share their investor experience. The roundtables are intended to gather information directly from investors who would be most affected by the SEC's rulemaking. SEC Chair Clayton highlighted several themes that he believes most valuable. First, retail investors believe the right way to regulate investment professionals is to have the core obligations of investment professionals match reasonable investor expectations. Second, retail investors want to maintain a choice

[2] We discussed the ARRC guiding principles more fully in Vol. 01, Issue 04 of REVERSEinquiries, available at: https://goo.gl/6J4M9E.

between being able to select a brokerage account, an investment advisory relationship or, in some cases having both. Third, the key differences between broker-dealers and investment advisers are not well-understood by retail investors. Chair Clayton claims the proposed SEC rules are intended to address this confusion by mandating a customer relationship summary that would highlight the services offered, the applicable legal standards of conduct, the fees a customer might pay, and any conflicts of interest. Fourth, retail investors don't want jargon from their investment professional or the SEC—they want clear questions and answers. Last, according to Chair Clayton, retail investors want to eliminate questionable sales practices, such as high-pressure, product-based sales contests. Chair Clayton's complete remarks can be found here: https://goo.gl/ZhftHz.

To provide feedback on the proposed rules, visit this site: https://goo.gl/Zw5YBs. Chair Clayton announced an additional roundtable to take place in Baltimore on September 20, 2018. More information about the event can be found here: https://goo.gl/xG1LCX.

SEC Commissioner Peirce's Remarks: "What's in a Name?"

In a speech titled "*What's in a Name? Regulation Best Interest v. Fiduciary*" SEC Commissioner Hester Peirce remarked on the differences between proposed Regulation Best Interest (Reg BI) and the "fiduciary standard." She also issued a strong critique of Reg BI and the "Form CRS" disclosure requirement.

Commissioner Peirce said that although words can carry a lot of meanings, what is most important is the context in which the words are used--"[i]n the end, it really isn't the title that someone uses, it's the standard to which they are held that matters." Substantively, she noted two major differences between Reg BI and the fiduciary standard. First, an adviser generally has ongoing duties to provide advice and monitor client's accounts over the course of the relationship, while a broker-dealer generally does not. Also, a broker-dealer would be required either to mitigate or eliminate any material financial conflict of interest it may have with its client whereas an adviser would be required only to disclose such a conflict. Commissioner Peirce advocates for a simpler standard of conduct for broker-dealers than that set out in Reg BI. Commissioner Peirce would not refer to the standard as, or include within the standard, the term "best interest." In addition, she noted one of the primary flaws with Reg BI is that it does not attempt to define "best interest." Commissioner Peirce argues that the word of "fiduciary" provides a false sense of security for retail investors. Commissioner Peirce is worried investors will be inhibited from asking investment professionals questions regarding their relationship. The objective of the proposed investor disclosure component of Reg BI, the Customer or Client Relationship Summary (Form CRS, *see*: https://goo.gl/8cdSgP), is to provide plain English disclosure and encourage a discussion between investment professionals and their customers. Form CRS is a document, of no more than four pages, that is to be delivered to outline the relationship summary. But for Commissioner Peirce, four more pages of legalese is not enough to protect retail investors. She noted that she looked forward to feedback on Form CRS from investors and others with experience in communicating with retail customers. Commissioner Peirce's full speech can be found here: https://goo.gl/Zn1TdA.

Regulators Call Attention to Non-Traditional Index Funds

FINRA recently released a news alert for investors on custom-built index funds.[3] Custom-built index funds, or non-traditional index funds, track custom-built indices that are constructed based on criteria commonly used by actively managed funds. FINRA's newsletter is substantially similar to the SEC Investor Bulletin[4] we discussed in a prior issue.[5] Both the SEC and FINRA highlight the potential risks associated with non-traditional index funds. These risks are similar to those associated with structured products linked to certain proprietary indices, such as the complexity of the underlying index, no guarantee of success, higher costs than traditional index funds and limited performance histories. The two investor alerts signal that issues associated with non-traditional investments are attracting regulatory attention.

What Financial Institutions Need to Know about Regulations on Elder Financial Exploitation

Elder financial exploitation has been recognized by many state and national agencies as a concern as the population ages and elders shoulder more responsibility for managing their retirement assets under defined contribution plans. For investment advisers and broker-dealers, balancing the protection of customer information and reporting financial exploitation is challenging. Fortunately, state and national authorities have taken actions to ease the regulatory tension.

STATE REGULATIONS

Most states have laws in place to address elder financial exploitation. Under state laws, a financial institution, such as an investment adviser or a broker-dealer, that complies with the rules is immune from civil and administrative liability for reporting suspected elder financial exploitation. State regulatory regimes that apply to financial institutions can be split into two groups: the permissive and the mandatory. Under the mandatory reporting regime, a financial institution has a duty to report suspected elder financial exploitation. In the permissive reporting regime, a financial institution reporting elder financial exploitation is immune from liabilities but has no obligation to report such exploitation. In addition, some state laws permit a financial institution to put a temporary hold on disbursals upon a reasonable suspicion of financial exploitation.

NATIONAL REGULATIONS

On the national level, three notable efforts were taken to address the elder financial exploitation. Earlier this year, FINRA amended two rules to curb elder financial exploitation. FINRA Rule 2165 allows a broker-dealer to place a temporary hold on disbursements from a client's account when elder financial exploitation is suspected. If the member firm places a hold on a customer's account, FINRA Rule 4512 requires the firm to take reasonable efforts to notify the trusted contact of that account to address possible financial exploitation.

[3] *Custom-Built Index Funds—Are You the Right Customer?* can be found at: https://goo.gl/3FoKVF.
[4] *Investor Bulletin: Smart Beta, Quant Funds and other Non-Traditional Index Funds* can be found at: https://goo.gl/W4AXTr.
[5] *Investor Bulletin on Nontraditional Index Funds Covers Issues Familiar to Structured Products Investors* can be found at: https://goo.gl/2nS895.

More recently, President Trump signed the Senior Safe Act of 2018 (the "Act") into law. The Act encourages reporting of elder financial exploitation by providing immunity for covered financial institutions that make reporting in good faith and with reasonable care. Covered financial institutions under the Act include credit unions, depository institutions, investment advisers, broker-dealers, insurance companies, insurance agencies, and transfer agents. The Act also encourages training at covered financial institutions by making the immunity from liability contingent on certain training specified in the Act. Under the Act, covered individuals and financial institutions will not be liable for disclosure of information made to certain state and federal regulatory agencies. The Act also has limited preemption provisions. State laws that do not provide immunities for covered financial institutions and individuals for reporting elder financial exploitation will presumably be preempted by the Act.

In addition, a recent bipartisan bill introduced in Congress titled the "National Senior Investor Initiative Act of 2018" proposes to create a task force within the SEC to focus on the challenges senior investors face. The task force would work with national and state authorities and issue biennial reports with recommendations for regulatory or statutory changes benefitting senior investors. Furthermore, the bill would require a study on direct and indirect costs resulting from elder financial exploitation.

POTENTIAL ISSUES

While the Senior Safe Act is a positive step towards a uniform regulatory regime on elder financial exploitation, it does not resolve all the issues. Because the Act has only limited preemption of state laws, there are potential inconsistent regulatory requirements across states.

Who are covered financial institutions and individuals?

Under the Act, covered financial institutions include credit unions, depository institutions, investment advisers, broker-dealers, insurance companies, insurance agencies, and transfer agents. The individuals covered under the Act are limited to certain individuals with specified roles. Under some state statutes, covered financial institutions include only depository institutions and credit unions, but all officers and employees of the covered financial institutions are covered.

Who are protected adults?

The Act only protects adults age 65 and older, while FINRA Rule 2165 and some state laws protect both elder adults and adults with a mental or physical impairment.

What is financial exploitation?

The definition of financial exploitation varies from state to state and from agency to agency. For example, under the Act, exploitation is defined to include "fraudulent or otherwise illegal, unauthorized, or improper act or process of an individual… that … results in depriving a senior citizen of rightful access to or use of benefits, resources, belongings, or assets." This definition does not require wrongful use. Some state statutes, on the other hand, require "wrongful use." Furthermore, only an individual is capable of committing financial exploitation under the Act and FINRA Rule 2165, while in some states, both an individual and entity are capable of committing financial exploitation.

Other considerations

Finally, even when reporting elder financial exploitation is optional, a financial institution should carefully consider the potential risks of inconsistent practices across different offices and the reputational risks in the event an incident of elder financial exploitation goes unreported. Consequently, a financial institution should balance the risk and benefits when developing or revisiting reporting policies and procedures. To be eligible for the immunity provided by the Act, a financial institution must implement training programs, or update existing programs, to meet the requirements of the Act.

Recent Amendments to Regulation S-K Affect Morgan Stanley Disclosure Requirements

As our readers are well aware, under the Morgan Stanley no-action letter relief, issuers of structured notes linked to equity securities may include abbreviated disclosure about the issuer of the underlying equity securities, provided that the issuer of the equity security has a class of equity securities registered under Section 12 of the Securities Exchange Act of 1934 (i.e., listed on a national securities exchange) and there is sufficient publicly available information about the issuer (generally, the underlying issuer is eligible to file a Form S-3, meaning that they have timely filed their Exchange Act reports in the prior 12 months).[6] An issuer that meets these tests is considered "Morgan Stanley eligible."

In accordance with these requirements, issuers of structured notes linked to equity securities generally include abbreviated disclosure about the equity security issuer, limited to a brief description of the issuer's business, disclosure about how to find that issuer's information on the SEC's website and historical information about the market price of the equity securities similar to that required by Item 201(a)(1) of Regulation S-K. This last requirement has been effectively done away with by the new amendments to Regulation S-K. On August 17, 2018, the SEC amended certain disclosure requirements that it considered to have become redundant, duplicative, overlapping, outdated or superseded, in light of other SEC disclosure requirements or changes in the information environment.[7] One of the Regulation S-K items that was amended is Item 201(a)(1). For a listed US issuer, current Item 201(a)(1) requires that the registration statement (or Exchange Act report or pricing supplement) disclose the name of the principal US market on which the issuer's common equity is traded and, if that principal US market is an exchange, the high and low sale prices of the common equity for each quarter within the two most recent fiscal years and subsequent interim period.[8]

In practice, issuers of structured notes linked to the common stock of Morgan Stanley eligible issuers include at least five full years of trading history, with some issuers including ten full years. One reason that some issuers have been including ten years of trading history is to capture the 2008 financial crisis. Issuers of structured notes linked to exchange-traded funds follow the same disclosure approach. Issuers of structured notes linked to indices also disclose historical data for the same time periods, although many include only a graph, rather than a table of high and low closing levels.

In the Release, the SEC amended the disclosure requirements of Item 201(a)(1) of Regulation S-K, noting that it is one of the disclosure requirements that has become obsolete as regulatory, business or technological environments have changed over time.[9] The SEC explained that daily market prices of most publicly traded

[6] Morgan Stanley & Co. Incorporated (June 24, 2006)
[7] *See* Release No. 33-10532 (Aug. 17, 2018) (the "Release") at 1.
[8] Item 201(a)(1)(i) and (ii) of Regulation S-K.
[9] *See* the Release at 101.

common equity securities are readily available on the internet for free, and investors can easily download data over customized time horizons.[10] Consequently, Item 201(a)(1) of Regulation S-K was amended to delete the requirement to include historical data in the registration statement. Regulation S-K retains the requirement to disclose the name of the principal US market on which the class of common equity is traded, but Item 201(a)(1) was amended to require disclosure of the ticker symbol of each class of common equity so traded.

Once the amendments are effective, structured note issuers linking to Morgan Stanley eligible issuers will be able to significantly shorten their descriptions of the underlying equity security issuer. They will only have to include a capsule business description, where to find the Morgan Stanley eligible issuer's Exchange Act reports and the name of the exchange and ticker symbol of the underlying common stock. It is most likely that structured notes issuers linking to ETFs and indices will also follow this approach.

The amendments to Regulation S-K and other SEC disclosure requirements will become effective 30 days after publication in the Federal Register.

The Upcoming Prospectus Regulation in the European Union: New Requirements for Risk Factors

The new EU prospectus regulation will become effective in July 2019. Most of the additional technical and implementing rules and regulations as well as guidelines for the national competent authorities are still not finalized. In future issues of the newsletter, we will provide updates on this new regulation, which will require issuers within the European Union to substantially revise and restructure their prospectus formats for the third time since 2005. We begin below with a discussion regarding the content of risk factors.

BACKGROUND

On June 20, 2017, Regulation (EU) 2017/1129[11] of the European Parliament and of the Council of June 14, 2017 (the "Prospectus Regulation"), governing the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, was published in the Official Journal of the European Union. The Prospectus Regulation became effective on July 20, 2017 and also repealed Directive 2003/71/EC. Although only a few provisions were effective as of July 20, 2017, the vast majority of the Prospectus Regulation's provisions will apply from July 21, 2019. The Prospectus Regulation will repeal and replace the national legislations implementing the prospectus directive (2003/71/EC) as well as the existing prospectus regulation ((EC) 809/2004).

In the next year, the Prospectus Regulation will change some fundamental parts of the existing prospectus practice in the European Union. It is therefore important for frequent issuers and issuers with continuous issuance programs to start preparing for the upcoming changes. Material changes include the following:

- The summary of prospectuses will be restructured.
- The presentation of risk factors will be subject to more detailed regulation.

[10] *See* the Release at 103.
[11] The Prospectus Regulation is available at: https://goo.gl/n245Jr.

- The minimum content requirements of prospectuses will be streamlined.
- There will be a universal registration document for frequent issuers.
- Issuers may draft and submit a voluntary prospectus for approval.
- There will be new prospectus formats for specific issuers or issues (for example, European growth prospectus).
- The language used in prospectuses will be simplified.
- The scrutiny and approval process applied by the National Competent Authorities ("NCAs") will be streamlined and made uniform.

As the Prospectus Regulation does not require implementation measures by the EU member states, it is expected that this will result in a greater harmonization of the format and content of prospectuses across the European Union. However, the vast majority of the new prospectus standards are still subject to detailed regulations by so-called level 2 and level 3 measures. The European Commission (the "Commission") and the European Securities and Markets Association ("ESMA") are mandated to develop the required rules and standards. To this end, ESMA published the first part of its technical advice on level 2 measures in its Final Report dated March 28, 2018[12] (the "Final Report") on (i) the format and content of the prospectus, (ii) the EU growth prospectus and (iii) the review and approval of prospectuses under the Prospectus Regulation following a public consultation[13] on these matters. Subject to approval by the Commission, ESMA's technical advice will form the basis for the delegated acts (level 2 legislation) to be adopted by the Commission by January 21, 2019. On July 13, 2018, ESMA published a Consultation Paper[14] on level 3 guidelines on risk factors under the Prospectus Regulation (the "Draft Guidelines"), as mandated under Article 16(4) of the Prospectus Regulation.[15] In addition, on July 13, 2018, a Consultation Paper[16] on the draft technical advice on minimum information content for certain prospectus exemptions was published. We summarize below the suggested disclosure requirements for risk factors.

DISCLOSURE REQUIREMENTS FOR RISK FACTORS

The main principles for the minimum content and format of risk factors are set out in Article 16 of the Prospectus Regulation. As stated in Recital 54 of the Prospectus Regulation, the primary purpose of including risk factors in a prospectus is to ensure that investors make an informed assessment of such risks and make investment decisions having knowledge of the risks. Risk factors should therefore be limited to those risks that are material and should be specific to the issuer (and/or the guarantor, if applicable) and its securities. A prospectus should not contain risk factors that are generic and only serve as disclaimers, given that these could obscure more specific risk factors of which investors should be aware, and would be inconsistent with the objective of presenting information in a concise and comprehensible form.

[12] The Final Report is available at: https://goo.gl/6A2uPk.
[13] The following consultation papers were published on July 6, 2017: Consultation Paper on the format and content of the prospectus (ESMA31-62-532), Consultation Paper on EU Growth prospectus (ESMA31-62-649), Consultation Paper on scrutiny and approval (ESMA31-62-650).
[14] The Consultation Paper is available at: https://goo.gl/TcVfNo.
[15] The Prospectus Regulation would also empower the Commission to adopt delegated acts specifying criteria for the assessment of the specificity and materiality of risk factors, but the publication of – flexible – guidelines seems to be the preferred approach of the Commission for this complex task.
[16] The Consultation Paper is available at: https://goo.gl/9EfJDz.

The risk factors shall be organized into a limited number of categories. Within each category the most material risk factors shall be mentioned first.[17] The total number of risk factors included in the summary of the prospectus shall not exceed 15.

In the Final Report, ESMA points out that risk factor disclosure should be prominently located and easily accessible. Accordingly, ESMA suggests that the risk factors section should be placed at the beginning of the prospectus after the summary or, in the case of a base prospectus, after the general description of the program. In addition, the relevant annexes to the Prospectus Regulation reflect the requirements for the disclosure requirements as set out in Article 16 of the Prospectus Regulation.[18]

THE DRAFT GUIDELINES

In its peer review on the prospectus approval process, ESMA identified "… the tendency of issuers to present very lengthy and non-specific risk factors along with information mitigating the risk factors to an extent that they are negated." ESMA points out that "… the inclusion of generic risk factors leads to the production of lengthy and cumbersome risk factor sections, which do not serve investors…" and aims to prevent the continuation of "… the practice of recycling 'boilerplate' risk factors, from previous or other prospectuses…." The objective of the Draft Guidelines is to address these issues. The Draft Guidelines are directly addressed to the NCAs and aim to provide NCAs with a means of ensuring that risk factors disclose material risks specific to the issuer in a concise manner. The Draft Guidelines aim "… to encourage appropriate, focused and more streamlined disclosure of risk factors, in an easily analysable, concise and comprehensible form." The Draft Guidelines cover (i) specificity, (ii) materiality, (iii) corroboration of the materiality and specificity, (iv) presentation of risk factors across categories, (v) focused/concise risk factors and (vi) risk factors in the summary. In the Draft Guidelines, ESMA points out that the concepts of specificity, materiality and corroboration are linked. Risk factors included in a prospectus should be both specific and material and it should be clear from the description of a risk factor that both criteria have been fulfilled.

The key concepts set out in the Draft Guidelines are:

- Each risk factor should identify and describe a risk that is relevant for the issuer/guarantor or the securities concerned.
- The NCA shall ensure that the risk factors contained in the prospectus have been included following a researched assessment of their specificity and should challenge the disclosure if the risk factors have not been drafted specifically for the issuer/guarantor or the securities and only serve as disclaimers, or where there is no clear and direct link between the issuer/guarantor or the securities and the risk factor.
- A risk factor should only be included in the prospectus if it is entity- and security-specific and material to an investment decision.
- The NCA shall challenge the inclusion of a risk factor or request a clearer explanation where the materiality of the respective risk factor is not apparent.

[17] In addition, the risk factors for a prospectus of a credit institution shall include a description of the risks resulting from the level of subordination of a security in the event of bankruptcy, or any other similar procedure, including, where relevant, the insolvency of a credit institution or its resolution or restructuring in accordance with Bank Recovery and Resolution Directive (2014/59/EU).

[18] *See*, for example, Section 2 of Annex 5 to the Prospectus Regulation.

- Where available, the disclosure of quantitative information, in order to illustrate the potential negative impact disclosed in a risk factor, should be included. Where quantitative information is not available, qualitative information could be included that demonstrates how the issuer/guarantor or the security is affected, or the extent to which it is exposed to the relevant risk factor.
- The NCA shall challenge the inclusion of mitigating language if the materiality of the respective risk factor is compromised by the inclusion of such language.
- Materiality and the specificity of a risk factor should be corroborated by the content of the prospectus.
- The presentation of risk factors across categories (depending on their nature) should aid investors in navigating the risk factors section and support the comprehensibility of the risk factors. A risk factor should only appear once and in the most appropriate category. The most material risk factors must be presented first in each category. However, it is not mandatory that all further risk factors within each category be ranked in order of materiality.
- Appropriate headings should ensure that each of the categories are identified within the risk factors section. Similar risk factors should be grouped together and should not be described under a separate category.
- The number of risk categories included in the prospectus should not be disproportionate to the size/complexity of the transaction and risk to the issuer/guarantor. In this regard, ESMA suggests a limit of ten categories in the case of a standard, single-issuer, single-security prospectus.
- Sub-categories should only be used where their inclusion can be justified on the basis of the particular type of prospectus.
- Risk factors should be presented in a concise form. To avoid “size inflation,” the volume of disclosure contained in the risk factors should be limited to only that information that is necessary for assessing the risks presented to investors.
- Where a summary is included in the prospectus, the order of the presentation of key risks should be consistent with the order of the risk factors in the risk factors section.

The deadline for comments on the Draft Guidelines is October 5, 2018. Market reactions on the Draft Guidelines raise two general areas of concern. First, market participants emphasize that the NCAs should adopt a flexible and proportionate approach in the application of the Draft Guidelines, taking into account the type of prospectus (e.g., for debt or equity securities), the type of investors (e.g., retail or wholesale investors) and the particular circumstances of the transaction to which the prospectus relates. Second, the disclosure of quantitative information in relation to the potential negative impact of a risk factor is regarded as problematic for issuers as this information may not be readily available. The assessment by issuers as to whether such quantitative information is available for a particular risk factor may result in considerable additional effort.

PRACTICAL IMPLICATIONS

For the first time in the history of the prospectus regime in the European Union, the presentation of risk factors becomes subject to more prescriptive regulation. Market participants should not underestimate the required changes to existing disclosure practices and should carefully plan the implementation measures.

The planned changes to the disclosure requirements for risk factors, and in particular the requirement to split up risk factors in categories and to rank risk factors according to their materiality, will require substantial revisions of the existing approaches to the disclosure of issuer and securities specific risk factors. This is especially true with respect to the requirement to quantify the probability and magnitude of the potential risks, in particular in base prospectuses containing multiple products with different features.

In practice, it will be crucial for issuers to demonstrate to the NCAs what issuers have done to:

- simplify disclosure,
- limit the length of disclosures,
- eliminate frequently used disclaimer language,
- overcome the assumption by ESMA of a "copy and paste" of risk factors across the market, and
- strike the balance between required information in a risk factor necessary to explain the risk and clearly describing the materiality of a specified risk.

Further, in view of the liability associated with incomplete prospectuses, an issuer will have to consider which of the currently used risk factors are general risks that may no longer be used. We expect, however, that certain securities-related risk factors will remain unchanged, but the language used in the risk factor disclosures might have to be simplified. We expect that the changes to the risk disclosure section in EU prospectuses will result in longer prospectus approval processes in the next two years until the NCAs have implemented their approval practices. Issuers should therefore manage their documentation updating processes for EU prospectuses, leaving substantial additional time for a lengthier review.

Rule 3a-5 Exemption and Non-Guaranteed Securities

Rule 3a-5 under the Investment Company Act of 1940 ("1940 Act") generally exempts a finance subsidiary from the definition of *investment company* and its relevant securities from the definition of *investment securities.* A finance subsidiary is a subsidiary that is organized to finance the operations of its parent company or companies controlled by its parent company. Rule 3a-5 requires the parent company of the finance subsidiary to unconditionally guarantee the finance subsidiary's debt securities and non-voting preferred stock issued to or held by the public. This means that, in the event of a default in payment on any of these securities, holders may institute legal proceedings directly against the parent company to enforce the guarantee without needing to proceed against the finance subsidiary first. However, no guarantee is required in the following instances where the securities were not deemed "issued or held by the public":

- *Where a finance subsidiary's non-guaranteed securities are issued exclusively in private placements under Section 4(a)(2) of the Securities Act of 1933 ("Securities Act") or Rule 506 of Regulation D thereunder.*[19] These securities are not "issued to or held by the public." The term *public* refers to those investors who acquire securities in a public offering and are members of a class of persons needing the protection of the securities laws. Sophisticated or accredited investors who acquire securities in a private placement are expected to be able to determine if further credit support or a

[19] PSEG Capital Corporation, No-Action Letter, July 13, 1988.

parent company guarantee is necessary or appropriate under the circumstances.[20] Providing an exemption for these privately placed securities is also based on the conduit theory underlying Rule 3a-5. The conduit nature of a finance subsidiary is a "function of: (1) the primary purpose of such subsidiary—that is, financing the business operations of its parent company or companies controlled by the parent company; (2) the investment in, or loans to, the parent company or companies controlled by the parent company of at least 85 percent of the proceeds of securities issuances; and (3) the assets of the finance subsidiary—that is, primarily notes issued by the parent company or a company controlled by the parent company."[21]

- *Where a finance subsidiary resells non-guaranteed securities to qualified institutional buyers ("QIBs") or to accredited investors in transactions not required to be registered under the Securities Act*.[22] After the SEC extended the Rule 3a-5 exemption to a finance subsidiary's private placement of its non-guaranteed securities, the same reasoning was relied upon to claim an exemption on resales of non-guaranteed securities under Rule 144A. In both instances, the securities were considered not "issued or held by the public."[23]
- *Where a finance subsidiary issues non-US securities to persons outside the United States in reliance on Regulation S*.[24] The securities issued in an offshore transaction pursuant to Regulation S are not considered having been "issued or held by the public." This is consistent with the purposes of the 1940 Act, the SEC's efforts to facilitate globalization of securities markets, and international comity. A contrary interpretation will subject a foreign issuer intending to use its finance subsidiary for both US and foreign financings to "unnecessary administrative burdens, without providing benefits to U.S. investors."[25]

Misselling of Leveraged ETNs Results in Monetary Penalties

Over the years, regulators, including the SEC and FINRA, have warned investors of the risks inherent in investing in complex exchange-traded products ("ETPs"), particularly leveraged exchange-traded funds and exchange-traded notes ("ETNs").[26] This time around, the SEC required a broker-dealer that was also a registered investment adviser to reimburse retail customers for losses due to unsuitable recommendations to buy and hold a three times leveraged ETN linked to the daily performance of an index of oil futures contracts. The broker-dealer failed to reasonably supervise its sales force with respect to their recommendations to their retail customers to treat the ETNs as "buy and hold" investments, despite disclosure in the prospectus that the ETNs were suitable for sophisticated investors who would monitor their investments daily.[27]

[20] *Id.*; *see also* SEC v. Ralston Purina Co., 346 U.S. 119 (1953).
[21] *Id.*
[22] Sony Capital Corporation, No-Action Letter, Apr. 27, 1992.
[23] *See* Sony Capital Corporation, *supra.*
[24] Société Générale and SGA Société Générale Acceptance N.V., No-Action Letter, Feb. 14, 1992.
[25] *Id.*
[26] *See, e.g.*, "Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors," FINRA Investor Alert (Aug. 18, 2009) at: https://goo.gl/mnJV9c.
[27] The SEC Order is available at: https://goo.gl/YjZP7L.

The broker-dealer had a simple idea for its customers – the price of a barrel of oil was low, so they would recommend to their retail customers that they invest in a security linked to oil. Sometime in the future (the broker-dealer knew not when), when the price of oil had increased, they would recommend to their retail customers that they sell their oil-linked investment, thus reaping the profits. Buy low, sell high; what could go wrong with that?

Just about everything:

- The representatives lacked a reasonable basis for the recommendation to buy and hold the ETN; the ETN prospectus clearly stated that it offered no direct exposure to the spot price of crude oil and that it was not designed for holding periods of longer than one day;
- The broker-dealer failed to establish and implement a reasonable supervisory system for determining whether its registered representatives had a reasonable basis for recommending that investors buy and hold non-traditional ETPs;
- Supervisors at the broker-dealer failed to provide training to its representatives concerning non-traditional ETPs so that they could form a reasonable basis for their recommendations;
- Supervisors at the broker-dealer failed to implement the existing specific policies and procedures pertaining to non-traditional ETPs and failed to devote adequate resources to supervising representatives; and
- The same errors were made with respect to sales by investment advisory representatives to investment advisory clients.

The ETN prospectus had sufficient disclosure and risk factors, about which the SEC had no complaint. Despite the disclosure, the registered representatives did not understand how the oil futures contract index worked. Some representatives read only small parts of the prospectus, the ETN's fact sheet or web site; others had read the prospectus and were aware of the warnings not to hold the ETN for more than a day. The retail customers held their ETN investment for more than 400 days, and lost approximately 90% of their investment. The SEC concluded that the broker-dealer violated Sections 15(b)(4)(E) and 15(b)(6) of the Exchange Act in that the failure to supervise the registered representatives caused a failure to prevent violations of Sections 17(a)(2) and (3) of the Securities Act. The failure to supervise their investment advisory representatives was a violation by the investment adviser of Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-7 thereunder.

Structured Products Association

Legal, Regulatory & Compliance for Structured Investments Summit 2018

THE ONE AND ONLY LEGAL, REGULATORY AND COMPLIANCE CONFERENCE IN 2018

Join Mayer Brown, as lead sponsor, and the Structured Products Association at the **Harvard Club in New York** on **Thursday, September 27, 2018**, for a symposium on legal, regulatory, tax and compliance issues. For updates and to register, visit: https://goo.gl/HAcLrT.

Current Agenda

8:00am- 8:30am	*Breakfast and registration*
8:30am- 8:45am	**Introduction** Keith Styrcula, Structured Investments Association
8:45am- 9:45am	**The Best Interest Rule, State Fiduciary Rules and Structured Products** Brad Busscher, Incapital LLC Steven Lofchie, Cadwalader, Wickersham & Taft LLP Daniel Nathan, Orrick, Herrington & Sutcliffe LLP
9:45am- 10:30am	**Tax Developments Affecting Issuers of Structured Products** Remmelt Reigersman, Mayer Brown LLP Mark Sargent, UBS AG Stephanie White, Bank of America Merrill Lynch
10:30am- 11:15am	**Regulatory Developments Affecting Structured Products (MiFID, PRIIPs and Benchmark Regulation)** Travis Batty, Deutsche Bank AG Joe Inzerillo, BNP Paribas Christopher Schell, Davis Polk & Wardwell LLP
11:15am- 12:15pm	**LIBOR and Proprietary Indices** Lee Ann Anderson, Greenberg Traurig, LLP Bradley Berman, Mayer Brown LLP Sean Davy, SIFMA Frans Scheepers, IHS Markit
12:15pm- 12:30pm	**Structured Unit Investment Trusts and Other Product Innovations** Oscar Loynaz, Alaia Capital
12:30pm- 1:15pm	*Lunch*
1:15pm- 1:30pm	**The Use of Distributed Ledger Technology: Using Blockchain to Issue CDs, Banknotes, and Structured Products** Havell Rodrigues, Adjoint, Inc.
1:30pm- 2:15pm	**Other Regulatory Developments, including Canadian Bail-In and TLAC Requirements; Proposed Changes to the Volcker Rule; Proposed Changes to FINRA's Quantitative Suitability Rule** Michael Lewis, Sidley Austin LLP Darren Littlejohn, Fried, Frank, Harris, Shriver & Jacobson LLP Anna Pinedo, Mayer Brown LLP
2:15pm- 3:00pm	**Front Office Session: How the Trading Desks' Best Practices Have Evolved** Kirk Haldeman, J.P. Morgan Private Bank Ian Merrill, Barclays Bank PLC Eric Yates, Raymond James Financial, Inc.
3:00pm- 3:20pm	**Bloomberg, Industry Leaders Discuss the Nomenclature Initiative and Legal Considerations** Nitin Ananda, Bloomberg L.P. Keith Styrcula, Structured Investments Association
3:20pm- 3:30pm	**The New Organizational Structure for the Structured Investments Association and Conclusion**

CLE credit for this program is pending.

Announcements

LinkedIn Group. Stay up to date on structured and market-linked products news by joining our new LinkedIn group. To request to join, please email reverseinquiries@mayerbrown.com.

Suggestions? *REVERSEinquiries* is committed to meeting the needs of the structured and market-linked products community, so you ask and we answer. Send us questions that we will answer on our LinkedIn anonymously or topics for future issues. Please email your questions or topics to: reverseinquiries@mayerbrown.com.

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