Electronic Platforms for Structured Notes – The Legal Issues

The age of electronic platforms for structured notes is upon us. There are at least three active and well-known platforms operating as of this writing, and a number of other such platforms are in development.

What are these platforms, how do they work, and what legal issues may arise in connection with their operation?

THE DREAM

In a perfect world created by a platform operator, issuers of structured notes (or their affiliated broker-dealers) would post their offering documents on the platform and broker-dealers, investment advisers registered under the Investment Advisers Act of 1940 (the "Advisers Act") ("RIAs") and perhaps also banks acting as fiduciaries with trading discretion over client accounts ("Banks" and, together with broker-dealers and RIAs, "Users") would arrange for the purchase of these products for customer accounts. Each User would already be party to a distribution agreement with the issuer or a dealer agreement with the affiliated broker-dealer, which would address the know-your-distributor requirements.

This process would be more or less the same whether the offer of the structured notes were registered under the Securities Act of 1933 ("Securities Act") or exempt from registration thereunder, such as a structured note issued by a bank and exempt from registration under Section 3(a)(2) of the Securities Act. Similarly, banks offering structured CDs also participate in these platforms.

A platform operator that charges the issuer transaction-based fees in connection with sales of securities that may be made in reliance on the platform will need to be registered as a broker-dealer with the Securities and Exchange Commission ("SEC") and be a member firm of the Financial Industry Regulatory Authority, Inc. ("FINRA"). Generally, however, the platform operator does not offer or sell the issuer's securities and is not in the distribution chain for the sale of the structured notes. Offers and sales are made by the issuer and its affiliated broker-dealer and/or distributors outside of the platform.

The platform operator often has a section of its website that may provide educational materials. These materials do not relate to, or offer, any particular security, but are generic in nature and discuss or explain

the features of structured products. These educational sections of the platform may also have teaching materials designed to assist in training associated persons of broker-dealers.

Often a platform may provide tools that allow Users to design a reverse inquiry structured product, and then submit that reverse inquiry request to all or some of the issuers for their consideration. On some platforms, once a User chooses a set of parameters, existing offerings that match the request will appear as options for the User to inquire about from the relevant issuer. A platform may provide backtested hypothetical performance information for the hypothetical structured product created in response to the inquiry.

At this juncture, platforms are not available to retail investors or to persons or entities beyond the groups identified above as Users.

WHERE DO OFFERS BEGIN AND END?

A communication that might be deemed to constitute an "offer to sell," "offer for sale" or "offer" of securities under Section 2(a)(3) of the Securities Act must either be registered under Section 5 of the Securities Act or be within an applicable exemption. For issuers posting offering documents and communicating with Users, the key issues include, among others:

- Making sure that offers of securities are made solely through the issuer's offering documents;
- Segregating content created by the platform provider from the issuer's offering documents; and
- Characterizing communications relating to securities outside of the issuer's offering documents as "indications of interest," which are not offers, or restricting the recipients of those communications.

A communication relating to a securities transaction between issuers and broker-dealers and RIAs that are also registered as broker-dealers (together, "Dealers") on a platform may be considered a sell-side communication. Therefore, it should not be deemed to constitute an "offer to sell," "offer for sale" or "offer" under Section 2(a)(3) of the Securities Act. These communications, however, likely constitute institutional communications under FINRA Rule 2210 (Communications with the Public), and, as a result, would be subject to the content requirements of that rule (essentially, that communications be fair and balanced).

Communications relating to offerings of securities between issuers and RIAs or Banks may be considered "offers" under the Securities Act, depending on the facts and circumstances. If so, these communications would be subject to the registration and filing requirements under the Securities Act, unless there were an available exemption for the communication. This conclusion is based on the theory that RIAs and Banks with investment discretion stand in the shoes of their clients as offerees.[1] These communications would

[1] To our knowledge, the SEC has never directly addressed this issue. The Division of Investment Management ("DIM") touched upon the issue by taking no action against what amounted to constructive prospectus delivery to an investor, by allowing a RIA to receive disclosure required to be delivered to its client. *See Goldman, Sachs & Co.*, SEC No-Action Letter (June 20, 2013). The DIM noted Goldman's suggestion that "prospectus delivery to an investor's agent should satisfy prospectus delivery requirements under Section 5 of the Securities Act of 1933." *Id.* at n10. However, the DIM also noted that the cited authority was not exactly clear on the subject: "Is delivery of a prospectus to the buyer's broker sufficient compliance with Section 5(b) by the seller and his or her broker, even though the buyer's broker never delivers the prospectus to the principal? *Presumably*, it is if the buyer's broker is authorized or otherwise empowered under general principals of agency law to receive delivery." [Emphasis added; footnote omitted.] *Id.* at n10, citing Loss, Seligman & Paredes, Securities Regulation, 6th Ed., Vol. I, Chap. 2 at B.6.f.1.

also be institutional communications under FINRA Rule 2210. Platform operators may choose to address this concern by either limiting RIA and Bank access to materials that are not related to any offering and/or clearly identifying communications between issuers and RIAs and Banks that are not related to a specific offering as "indications of interest."

ISSUER OFFERING DOCUMENTS AND PLATFORM MATERIALS

Perhaps the most important concern for issuers posting their offering documents on a platform is that the content created by the platform provider might be considered by a Dealer, RIA or Bank (or worse, a regulator) to be part of, or subsumed in, the issuer's offering materials. Issuers do not want to be liable for offering materials other than their own. If the platform provider's materials were deemed part of an issuer's offering materials, a number of concerns might be raised: whether the platform provider's materials ought to have been filed by the issuer with the SEC (in the case of a registered offering), whether the platform provider's materials are fair, balanced and not misleading, and whether the platform provider's materials are consistent with the issuer's offering documents. The concerns may be amplified for issuers of registered securities that are not well-known seasoned issuers (as defined in Rule 405 under the Securities Act) with limited use of free writing prospectuses.[2]

In order to address this concern, issuers and platform operators clearly identify, label and segregate issuer materials from platform materials to ensure that Users will have no confusion about the source of the materials. Also, platform operators clearly identify when communications between issuers and Users are pre-offer "indications of interest" and when they are actual offers (to the extent that a platform provides this functionality) of the structured products, which can only be made through the issuer's approved offering materials.

ELECTRONIC MEDIA RELEASE

The SEC has provided limited guidance regarding internet-based delivery of offering related information. The relevant theories (cul-de-sac, envelope, entanglement and adoption) are all quite dated, born when the internet was still new.

Interpretive Release 33-7856 (Apr. 28, 2000)[3] (the "Electronic Media Release") did not relate to an electronic platform. The relevant question addressed in the Electronic Media Release was how and whether hyperlinks to third-party information on an issuer's website might cause the issuer to be liable for that third-party information under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder.

In the Electronic Media Release, the SEC discussed the prevailing theories of issuer liability for a third-party's hyperlinked information on the issuer's website. Under an "entanglement" theory, issuer liability for hyperlinked information could arise from, and would depend on, the issuer's level of pre-publication involvement in the preparation of the information. Under the "adoption" theory, liability would depend

[2] Under Rule 163(e)(2) of the Securities Act, ineligible issuers (those that are not well-known seasoned issuers) may use a free writing prospectus for limited purposes. If platform content were deemed to be an ineligible issuer's free writing prospectus, the platform content would most likely exceed the limitations of Rule 163(e)(2).

[3] The Electronic Media Release is available at http://bit.ly/34EYN75.

upon whether, after the publication of the third-party information, an issuer, explicitly or implicitly, endorsed or approved the hyperlinked information.[4]

The SEC discussed some relevant factors, "neither exclusive nor exhaustive," that should be considered in assessing whether hyperlinked information would be attributable to an issuer, and stated that it was not establishing a "bright-line mechanical test":

- What does the issuer say about the hyperlink?
    - A strong positive statement by the issuer could be considered an endorsement (resulting in an adoption of the third-party information);
- Even if the issuer is silent about the hyperlink, the context in which the issuer places the hyperlink may imply that the hyperlink is attributable to the issuer;
- Third-party hyperlinks embedded in prospectuses should always be deemed an adoption by the issuer of the hyperlinked information;[5] and
- A hyperlink in an issuer's website to information that constitutes an offer to sell gives rise to a strong inference that the issuer has adopted that information for purposes of Section 10(b) of the Exchange Act.[6]

If the factors listed above are satisfied, it may lead to the conclusion that the hyperlinked information on an issuer's website is attributable to the issuer. However, the SEC also discussed factors to be considered in determining that hyperlinked information on an issuer's website would not be attributable to the issuer.

In the Electronic Media Release, the SEC stated that an issuer may avoid adoption of the third-party information as its own "if the issuer makes the information accessible only after a visitor to its web site has been presented with an intermediate screen that clearly and prominently indicates that the visitor is leaving the issuer's web site and that the information subsequently viewed is not the issuer's. Similarly, there may be less likelihood of confusion about whether an issuer has adopted hyperlinked information if the issuer ensures that access to the information is preceded or accompanied by a clear and prominent statement from the issuer disclaiming responsibility for, or endorsement of, the information."[7]

So how might we apply the guidance in the Electronic Media Release to electronic platforms? Some facts are fundamentally different – an electronic platform is not an issuer's website, and the issuer is not providing hyperlinks to third-party content. Instead, an issuer is posting offering documents for securities offerings on a website hosted by a platform provider, where Users can access the issuer's offering documents and also the platform provider's content, with varying degrees of ease or difficulty.

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[4] In a related discussion in the Electronic Media Release, the SEC stated that if an issuer includes in its prospectus a hyperlink to a third-party website, the third party information will be become part of the prospectus, should be filed as part of an effective registration statement and would be subject to liability under Section 11 of the Securities Act.

[5] In response to this guidance, structured products issuers of index-linked notes tend either not to include in their prospectuses a link to the index sponsor's methodology or, if a link is included, make the link inactive and follow it immediately by a disclaimer. See the discussion below.

[6] *See generally* the Electronic Media Release at II.B.1.

[7] Electronic Media Release at II.B.1.(b).

The objective is to identify clearly for Users who "owns" which documents, and to erect barriers or signposts alerting Users when they are accessing issuer or platform content. The following methods are based on, and intended to comply with, the Electronic Media Release:

- Screens on a platform should be clearly identified as either issuer or platform content, by means of a clear and legible header or footer;
- Avoid intermingling platform content and issuer content on a platform screen;[8]
- Platform content (such as educational materials and tools allowing Users to "create" reverse inquiry notes) should include a statement that the issuer has neither reviewed, endorsed or approved the platform content and that the platform content is not an offer to sell, or a solicitation of an offer to purchase, any securities;
- When a User is on a part of the electronic platform that is considered the platform's content and then navigates away from the platform content to an issuer's offering materials, the User should first encounter either (i) a landing page clearly spelling out that the User is leaving the platform content and going to the issuer content, and that the platform content is not part of the issuer's offering documents, or (ii) a popup with the same content in the form of a clear and prominent disclaimer;
    - The reverse should be considered when leaving an issuer's offering materials and going to platform content; and
- Users should be clearly told that an offer of securities can only be made by means of an issuer's offering documents, and that any activities such as creating hypothetical or reverse inquiry notes and communications by issuers in response thereto are solely indications of interest and not offers.

Of course, the SEC has not updated the guidance contained in the Electronic Media Release in some time, and the guidance, as indicated above, did not address the particular facts at issue, so it should be understood in that context.

DEALERS v. RIAs v. BANKS – WHAT'S THE DIFFERENCE?

Communications by a broker-dealer, such as a platform operator, with broker-dealers, RIAs and Banks likely are "institutional communications" within the meaning of FINRA Rule 2210. As discussed above, institutional communications are subject to FINRA's content, review and recordkeeping requirements, but are not required to be filed with FINRA.

The backtesting feature of an electronic platform, as an institutional communication, is subject to FINRA's requirements for presentation of such data as stated in the FINRA ALPS Letter.[9] Consequently, backtested data should contain a legend clearly identifying it as such, pointing out that such data is hypothetical and subject to interpretation and that it should not be relied upon to forecast future performance.

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[8] In fn 37 of the Electronic Media Release, the SEC stated that "[t]wo or more documents will be considered to be delivered together if the buttons are in proximity to each other on the same screen …."

[9] The FINRA ALPS Letter is available at: http://bit.ly/34DJYkY. The guidance in the ALPS Letter was recently reiterated in the context of funds using backtested data in the Foreside Letter, available at: http://bit.ly/2K3dfhr.

If communications by a broker-dealer, such as investment suggestions made through the facilities of an electronic platform, were deemed to constitute recommendations of an investment strategy to a customer, then questions might arise as to compliance by the platform operator with the FINRA suitability requirements under Rule 2111. However, other dealers are not considered "customers" for purposes of FINRA Rules 2111 and 0160. Consequently, Dealers accessing platform content would not receive any recommendation of an investment strategy and Rule 2111's suitability requirements should not be implicated.

However, Banks likely would be considered customers for purposes of the FINRA rules. If platform content provided to a Bank were to be considered a recommendation of an investment strategy for purposes of Rule 2111, a Bank, as an institutional account under FINRA rules, might agree that it makes its own suitability determinations. In that instance, that platform content might be considered a recommendation under Rule 2111.

CONTRACTUAL APPROACHES

Issuers and platform operators generally will enter into an agreement setting forth responsibilities and also allocating liabilities. In a typical platform agreement, the platform operator will represent and warrant that it is not acting in an underwriter capacity, will not resell securities or act in any capacity as a dealer or distributor, and that the platform operator is not engaging in any activities that would require it to register as an investment adviser under the Investment Advisers Act.

Each party will indemnify the other against liabilities arising from a breach of a representation or warranty. The issuer will also indemnify the platform operator against any losses arising from (i) an untrue statement or alleged untrue statement of a material fact contained in any of the issuer's offering documents or (ii) the omission or alleged omission to state in the issuer's offering documents a material fact required to be stated therein or necessary to make the statements therein not misleading. The platform operator will indemnify the other parties for losses arising from (i) an untrue statement or alleged untrue statement of a material fact contained on the platform or in any information on the platform included by the platform operator (including content created by the platform operator) or (ii) the omission or alleged omission to state on the platform or in any information on the platform included by the platform operator (including content created by the platform operator) a material fact required to be stated therein or necessary to make the statements therein not misleading. The parties will generally agree in advance on the content of disclaimers, intermediate screens and pop-ups designed to comply with the guidance in the Electronic Media Release, and also on the content of any legend used when presenting backtested information.

CONCLUSION

Issuers and platform operators should take care to identify ownership of all materials on the platform, keep platform content separate from issuer content, follow by analogy the guidance in the Electronic Media Release, and inform Users as to when they are in pre-offer discussions and when an offer of a security is made.

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