

THE STRUCTURED
PRODUCTS
LAW REVIEW

THIRD EDITION

Editors

Christopher S Schell, Yan Zhang and Derek Walters

THE LAWREVIEWS

THE
STRUCTURED
PRODUCTS
LAW REVIEW

THIRD EDITION

Reproduced with permission from Law Business Research Ltd
This article was first published in October 2021
For further information please contact Nick.Barette@thelawreviews.co.uk

Editors

Christopher S Schell, Yan Zhang and Derek Walters

THE LAWREVIEWS

PUBLISHER

Clare Bolton

HEAD OF BUSINESS DEVELOPMENT

Nick Barette

TEAM LEADERS

Joel Woods, Jack Bagnall

BUSINESS DEVELOPMENT MANAGERS

Rebecca Mogridge, Katie Hodgetts, Joey Kwok

RESEARCH LEAD

Kieran Hansen

EDITORIAL COORDINATOR

Leke Williams

PRODUCTION AND OPERATIONS DIRECTOR

Adam Myers

PRODUCTION EDITOR

Martin Roach

SUBEDITOR

Nadine Catto

CHIEF EXECUTIVE OFFICER

Nick Brailey

Published in the United Kingdom

by Law Business Research Ltd, London

Meridian House, 34–35 Farringdon Street, London, EC4A 4HL, UK

© 2021 Law Business Research Ltd

www.TheLawReviews.co.uk

No photocopying: copyright licences do not apply.

The information provided in this publication is general and may not apply in a specific situation, nor does it necessarily represent the views of authors' firms or their clients. Legal advice should always be sought before taking any legal action based on the information provided. The publishers accept no responsibility for any acts or omissions contained herein. Although the information provided was accurate as at October 2021, be advised that this is a developing area.

Enquiries concerning reproduction should be sent to Law Business Research, at the address above.

Enquiries concerning editorial content should be directed
to the Publisher – clare.bolton@lbresearch.com

ISBN 978-1-83862-831-4

Printed in Great Britain by

Encompass Print Solutions, Derbyshire

Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

ALLEN & OVERY

ATTORNEYS-AT-LAW TRUST LTD

BOMCHIL

CLARO & CIA

DAVIS POLK & WARDWELL LLP

LECOCQASSOCIATE

NISHIMURA & ASAHI

PINHEIRO NETO ADVOGADOS

CONTENTS

PREFACE.....	v
<i>Christopher S Schell, Yan Zhang and Derek Walters</i>	
Chapter 1	ARGENTINA..... 1
<i>Fernín Caride, María Victoria Funes, María Victoria Tuculet and Lucía Carro</i>	
Chapter 2	BRAZIL..... 11
<i>Tiago A D Themudo Lessa, Rafael José Lopes Gaspar and Fábio Moretti de Góis</i>	
Chapter 3	CHILE..... 23
<i>José Luis Ambrosy</i>	
Chapter 4	FINLAND..... 36
<i>Mika J Lehtimäki</i>	
Chapter 5	JAPAN 47
<i>Naoya Ariyoshi, Yuki Taguchi and Toshiyuki Yamamoto</i>	
Chapter 6	LUXEMBOURG..... 57
<i>Frank Mausen, Paul Péporté, Jean Schaffner, David Van Gaever, Franz Kerger and Kristina Vojtko</i>	
Chapter 7	SWITZERLAND 70
<i>Dominique Lecocq and Lucile Cesareo-Hostettler</i>	
Chapter 8	UNITED STATES 84
<i>Christopher S Schell, Yan Zhang and Derek Walters</i>	
Appendix 1	ABOUT THE AUTHORS..... 117
Appendix 2	CONTRIBUTORS' CONTACT DETAILS..... 125

PREFACE

It is our pleasure to continue to act as the editors for this third edition of *The Structured Products Law Review*. Despite the significant growth of the global structured products market in recent years and the continuing evolution of the global regulatory framework, very few books on legal and regulatory issues related to structured products are available. Our first edition two years ago was meant to cover that gap, and we hope that this third edition will continue to further the knowledge base of legal practitioners and other structured products market participants.

For this year, we are pleased to report that this third edition adds one new jurisdiction and updates each existing geographical overview to cover its developments over the past year. One of the major developments, of course, has been the global covid-19 pandemic and the societal and governmental responses to that health risk. One of the more interesting effects of the pandemic for the structured products market was the intense volatility of the global stock markets in March and April 2020 as the world grappled with the new virus and its economic consequences. The volatility index of Chicago Board Options Exchange, known as the VIX index, reached a peak of 82.7 on 16 March 2020, which was higher than during the 2008 financial crisis and significantly higher than its long-run volatility average of approximately 20. This volatility resulted in substantial pricing movements in the structured products market. Combined with high levels of investor demand and longer marketing periods for typical structured products, and thus longer periods between the indicative pricing at launch and the final pricing at the close of the marketing, this unprecedented volatility required significant issuer and distributor efforts to appropriately price and sell structured products to those who understood the risks. Many transactions needed restructuring or repricing. At the same time, the investors saw the value of capital protection, including features such as buffers and triggers. The ultimate effects of this market dislocation, including any regulatory response, will take a long time to unravel. The near term results, however, are unambiguous: investors clearly noticed that structured products provided them with a set of investment options to capitalise on, or mitigate against, those unparalleled market conditions.

For our purposes, the term structured product refers to a pre-packaged investment that combines derivatives with other financial instruments to provide a return based on the performance of one or more underlying assets, including equity securities, indices, commodities, interest rates, currencies and, in some jurisdictions, credit risks. Typical structured products are issued as debt securities, certificates of deposit or investment certificates or units, and include embedded derivatives to provide a customised risk-return trade-off. Common issuers of structured products are financial institutions, other corporate issuers, special purpose vehicles and trusts. Structured products should not be confused with

other structured finance products, which include asset-backed securities such as collateralised debt obligations and mortgage-backed securities, synthetic loans and credit derivatives such as credit default swaps.

Structured products have been in the spotlight since the global financial crisis in 2008. In the years following the financial crisis, there was an increase in regulatory investigations into the issuance and distribution of structured products and the promulgation of new rules and regulations to govern the conduct of structured product issuers and distributors. Regulators are particularly concerned about certain risk characteristics of structured products, including credit risk, investor suitability, pricing transparency, secondary market liquidity and conflicts of interest. Global regulators have taken a range of approaches to address these issues. To enhance investor protection, the International Organization of Securities Commissions published a report on the regulation of structured products in December 2013, which provides a toolkit outlining possible regulatory options that regulators in different jurisdictions may find useful to address their concerns about structured products. The process that led to the publication of this report has helped increase regulatory consistency across different jurisdictions and is an excellent example of international collaboration. The growing popularity of complex structured products among retail investors has also caught regulators' attention. Pursuant to the EU Markets in Financial Instruments Directive legislation that came into effect in January 2018, an issuer is required to supplement offering materials with a key information document when offering structured products to retail investors in EU Member States in order to strengthen investor protection and improve their investment decision and selection process. Other jurisdictions have also implemented rules aimed at protecting retail investors.

Given its unique ability to tailor investments to investor preferences, the structured product industry continues to grow at an impressive pace, and it is estimated that the size of outstanding structured products around the world has increased to over US\$3 trillion in 2021. Technology plays an increasingly important role as the structured product market continues to grow in terms of issuance volume, innovation and broadening distribution channels. Recent examples include the growing popularity of online distribution platforms that provide an open marketplace for structured product issuers and distributors with a focus on streamlining the offering process to increase efficiency and transparency, the development of blockchain technology to facilitate securities clearing and settlement, and the use of large volumes of data from non-traditional sources, such as social media, to assess investors' financial needs and to design investment strategies. In recent years, not only have market participants embraced the rise of fintech by integrating new technology into offerings and issuances of structured products, securities regulators are also exploring the possibility of adopting new technology in structured product regulation. In Japan, online-based procedures have been permitted since November 2018 as a new know-your-customer (KYC) process to complement traditional face-to-face or mail-based KYC procedures. The US Securities and Exchange Commission (SEC) also has explored the use of big data in enforcement actions. In one recent example, the SEC used for the first time a coding technique against a broker-dealer that allows regulators to analyse data across an entire trading platform to identify potential unsuitable sales to a particular class of investors. The financial industry has historically been an early adopter of new technologies. With the onset of the remote working environment in many jurisdictions due to covid-19, the industry saw a continued investor demand for structured products throughout 2020 and 2021 and the technology was available

to deliver structured products to those investors notwithstanding the dramatic decrease in in-person interactions. There is no doubt that technological development will continue to have a profound impact on structured products markets across all jurisdictions.

The Structured Products Law Review is designed to provide an overview of recent changes and developments in legal and regulatory issues regarding structured products markets. It would not have come together without the participation of a group of top lawyers and law firms from eight jurisdictions around the world. We hope that you find this book a useful tool in navigating the ever-changing legal and regulatory landscape in a fast-growing industry.

Finally, we would like to thank our counsel, Vidal Vanhoof, and other colleagues for their contributions in editing this book and the team at Law Business Research for their patience and efforts in compiling this third edition.

Christopher S Schell, Yan Zhang and Derek Walters

Davis Polk & Wardwell LLP

New York

October 2021

UNITED STATES

Christopher S Schell, Yan Zhang and Derek Walters¹

I OVERVIEW

The structured products market in the United States has undergone tremendous change in the past dozen or so years since the ending of the global financial crisis. The overall market of new issuances increased to over US\$67 billion a year in 2020, with over 21,182 aggregate number of deals issued on a Securities and Exchange Commission (SEC)-registered basis.² Despite the global covid-19 pandemic and the resulting market volatility, new issuances grew to over US\$58 billion for the first eight months of 2021, a significant increase of over 22 per cent from the same period in 2020.³ The product mix has changed and a wider variety of equity-linked products are available today, with many products routinely issued today that were unavailable 10–12 years ago. Tremendous variation in the manner of issuing structured products now exists in the United States, including large institutional or high net worth private offerings, SEC-registered retail offerings and offerings of structured certificates of deposits issued by regulated banks. In addition, the distribution model for selling structured products in the United States has undergone arguably the most change. Many existing large wealth management or financial advisory firms have embraced the concept of ‘open architecture’. Whereas in the past, these firms would typically restrict their sales to products issued by their affiliates, now they encourage non-affiliated structured product issuers to use their distribution platforms. Supplementing, and at times competing with, the sale of structured products by these large broker-dealers is an increase in sales of structured products by independent wholesale or intermediate distribution firms, as well as increasingly independent financial advisers, often acting in a fiduciary capacity for their investor clients. New issuers, primarily financial institutions based in Canada and Europe, have entered the marketplace. Finally, dedicated structured product electronic platforms have been created to allow brokers to access product information, as well as educational materials, and to purchase products, through website portals created for these purposes. Those multi-dealer electronic platforms and individual dealer’s separate electronic platforms played a key role in the ability of this market to withstand the covid-19 in-person restrictions. The role and rules of the

1 Christopher S Schell, Yan Zhang and Derek Walters are partners at Davis Polk & Wardwell LLP. The authors would like to thank their colleagues Vidal Vanhoof, Michael J Russo and Crystal Jen for their assistance with this chapter. They would also like to thank their colleague Po Sit for his assistance with the tax section of this chapter and colleagues Randall D Guynn, Gabriel D Rosenberg and Dana E Seesel for their assistance with the bank regulatory section of this chapter.

2 The Prospect News, *Structured Products Daily*.

3 The Prospect News, *Structured Products Daily*.

various regulators in the United States tasked with supervising this market has evolved with the market. This chapter addresses the regulatory framework that has been built to address this expanding and changing marketplace.

One of the central tensions for the US regulators grappling with this changing landscape has been between the perspective that the market is benefiting from democratisation versus the view that it is subject to inappropriate 'retail-isation'. The principal US regulator, the SEC, has made clear that it will not determine the merits of any given structured product or otherwise proscribe products in light of the view that the continued depth of the US capital markets benefits from new product introductions. This view stems from the bedrock belief that investors should be able to make their own investment decisions, even with complex products, so long as they have full and accurate disclosure with which to make their investment decision. This approach stems from the belief that individual investors can benefit from products that were only available to large institutional investors in the past and thereby democratises the investment landscape. On the other side, regulators are clearly concerned that not all retail investors will benefit from these products, whether they do not have the financial experience necessary to understand the products or whether unscrupulous distributors recommend unsuitable investments to them. From this perspective, the SEC and perhaps even more so the Financial Industry Regulatory Authority, Inc (FINRA), a self-regulatory organisation regulating broker-dealers, have created new rules and regulatory frameworks to police the market for complex products covering a range of issues. While these new rules have not always exclusively targeted structured products, they evince concerns that retail investors need careful protection when facing investment decisions relating to the retail-isation of complex financial instruments. These intertwined regulatory initiatives have addressed a wide variety of issues, including conflicts of interests, fees and commissions, sales to retirees, distribution governance procedures, and supervision and complex product creation and marketing more generally.

The regulatory environment in the United States is made more complex by the fact that structured products are primarily issued by heavily regulated bank holding companies. These banks are subject to a myriad of bank capital, resolution planning and similar regimes that directly affect capital markets transactions, including structured products. For example, the Board of Governors of the Federal Reserve System (Federal Reserve) has formalised rules regarding eligible long-term debt that have had a major impact on structured products, and which types of entities can issue them, as described in this chapter.

Two primary themes underlie the current regulatory regime for structured products. The first is the direct message from the regulators that providing clear, accurate product disclosure to investors is not always sufficient. The rules promulgated by the principal regulators focus on appropriate governance of the product creation process and sufficient oversight of the sales process, even to the extent where the product issuer must, in some circumstances, take certain actions to monitor and assess the sales process by independent third-party distributors of the issuer's products. This focus evinces the regulators' concerns that certain sales efforts can, in some circumstances, amount to a concerning level of pressure on less financially sophisticated retail investors of products. As such, these regulators have taken the view that the creators and issuers of these products are well placed to understand the benefits and risks of their products and so should act as one of the gatekeepers to ensure they are sold only to suitable investors. The second is that the US regulators have retained the post-financial crisis activism in enforcement. This trend has meant that while a number of landmark enforcement actions occurred in the aftermath of the crisis as the regulators took a

more activist approach to enforcement, the enforcement task forces remain active to this day. Given that this focus has now spanned three different presidential administrations, including the Trump Administration, it is fair to say that it likely reflects a bipartisan approach to the enforcement of the laws and regulations governing complex products sold to individual investors, including structured products. While the enforcement of existing laws and regulations has bipartisan support, further regulation of the industry is a more complex issue. The elevation of Gary Gensler as chair of the SEC, with his known interest in regulatory change from his days as chair of the Commodity Futures Trading Commission in the early 2010s, could alter this landscape in ways that are currently hard to foresee.

This chapter explores how these trends manifest themselves in the overall regulatory landscape. It discusses the roles and legal regimes of the various US regulators of structured products from the SEC and FINRA to state law regulators, and specific issues such as the sales and marketing rules, Regulation Best Interest, exchange listing issues, the rules governing the use of distributors, such as know-your-distributor (KYD) requirements, and cash tender offers for structured products. It also addresses the evolving situation at the Department of Labor over its protean DOL Fiduciary Rule that the new presidential administration has telegraphed may again be amended in the upcoming year. As the United States and the world deal with the ongoing covid-19 pandemic, which is causing unprecedented changes to daily life and turmoil in financial markets, this chapter discusses the impact of this global health crisis on the disclosure, marketing, pricing and trading of structured products. In general, the chapter is organised thematically to address these principal regulatory rules and related concerns raised by regulators. We also cover generally the typical US tax treatment of structured products and other issues that touch upon structured products, such as the upcoming transition away from LIBOR.

II LEGAL AND REGULATORY FRAMEWORK

i US securities laws and the role of the SEC

Most structured products issued in the US market are issued as securities or certificates of deposit (CDs).

The Securities Act of 1933, as amended (the Securities Act), regulates offers and sales of securities in the United States. All offers and sales of securities must be made pursuant to a registration statement, except for certain exempt securities and exempt transactions. Every offering needs to be registered or rely on an exemption from registration: it is the specific offering that is registered, not a series or class of securities. If no exemption is applicable, under the central provision of the Securities Act, Section 5, it is unlawful to offer a security unless a registration statement has been filed as to the security, and it is unlawful to sell a security unless a registration statement is in effect as to the security.

A registration statement is a filing with the SEC that includes a base prospectus, which contains general information about the issuer and the securities being registered. Disclosure about the issuer in its annual, quarterly and other periodic reports is typically incorporated

by reference into the base prospectus. The SEC is a government agency that is the primary overseer and regulator of the US securities markets. Its mission is ‘protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation’.⁴

Registration statements are subject to review by SEC staff, although the SEC states that it ‘does not evaluate the merits of securities offerings, or determine whether the securities offered are “good” investments or appropriate for a particular type of investor’.⁵ Registration statements become effective upon SEC declaration or, in certain cases, automatically. Filing fees are payable to register securities with the SEC (currently US \$92.70 per US\$1 million of securities (with effect from 1 October 2021)).

Exemptions from registration include:

- a* Rule 144A: a safe harbour exemption for resales of securities to qualified institutional buyers (essentially, large institutional investors);
- b* Regulation D: exemptions for sales of securities to accredited investors (which include certain institutional investors, as well as high-income or high net worth individuals);
- c* Regulation S: safe harbours for offers and sales that occur outside the United States; and
- d* Section 3(a)(2): an exemption for securities issued or guaranteed by a bank or a regulated US branch or agency of a non-US bank.

CDs are issued by banks and insured by the Federal Deposit Insurance Corporation up to applicable limits. Structured CDs always provide for the repayment of the deposit amount at maturity. CDs are generally not securities for the purposes of the Securities Act and, therefore, are not required to be registered thereunder. However, similar risk and disclosure considerations apply. As a result, typical market practice is for the disclosure package about a structured CD to be relatively equivalent to the disclosure package about an SEC-registered security.⁶

US securities laws generally impose liability for material misstatements and omissions in the offering documents. The applicable standard, persons subject to liability and potential defences depend in part on whether the securities are SEC-registered.

The typical disclosures provided to investors in SEC-registered structured product offerings can be divided into three broad categories:

- a* Disclosure about the issuer: typically, structured products are issued or guaranteed by an entity that is subject to extensive ongoing reporting requirements. Those disclosures, which are made in public filings, are typically incorporated by reference into the base prospectus or similar base offering document (such as the offering memorandum or offering circular).
- b* Disclosure about the structure and related adjustment mechanics: these disclosures are typically contained in one or more of the offering documents that supplement the base offering document (such as a prospectus supplement or product supplement or the preliminary and final pricing supplements).
- c* Disclosure about the underlying reference asset or assets. These disclosures are typically contained in one of the offering documents that supplements the base offering

4 US Securities and Exchange Commission, ‘What We Do’: <https://www.sec.gov/Article/whatwedo.html> (accessed 8 July 2021).

5 US Securities and Exchange Commission, ‘Small Business and the SEC’: <https://www.sec.gov/reportspubs/investor-publications/infosmallbusqasbsechtm.html> (accessed 8 July 2021).

6 Typical plain vanilla CDs have very abbreviated disclosure, often limited to the term and interest rate.

documents (such as an underlying supplement or the preliminary and final pricing supplements). However, under a 1996 no-action letter, the SEC staff has granted relief to issuers of securities linked to equity securities issued by another (unaffiliated) issuer (underlying company) if the issuer does not have any material non-public information about the underlying company and where there is sufficient market interest in and publicly available information regarding the underlying company. In this case, the issuer may refer investors to disclosures made by the underlying company without having to take liability for such disclosures. The SEC staff has extended this analysis to exchange-traded funds (ETFs). Starting in December 2020, issuers began to launch SEC-registered structured notes linked to actively managed ETFs. Since then, issuers have launched hundreds of offerings linked to one or more actively managed ETFs. Most issuers have included cover page and risk factor disclosure relating to active management.

ii Broker-dealer regulation and the role of FINRA

FINRA is a non-governmental self-regulatory organisation that regulates member broker-dealer firms. Most issuers of structured products are affiliated with one or more broker-dealers that are members of FINRA and need to comply with its rules. FINRA has long been focused on structured and complex products and other issues relevant to structured products, such as communications with the public, conflicts of interest, suitability and KYD policies and procedures. Some of FINRA's key relevant guidance in these areas is summarised in Section III.

iii State securities laws

Each state has its own securities laws (often referred to as 'blue sky laws'). These state laws frequently prescribe registration or qualification requirements that apply to securities, including SEC-registered securities, unless such requirements are pre-empted pursuant to Section 18 of the Securities Act. Because issuers of structured products typically list at least one class of their equity (or debt) securities on a national securities exchange, these state law requirements will be pre-empted for all of its securities (including structured products) that rank equal or senior to that listed security so long as that listed security remains outstanding and listed.

However, even if the registration and qualification requirements are so pre-empted, state securities laws may still require notice filings or payment of fees. In addition, state securities regulators retain the ability to bring actions under state laws that, for example, prohibit fraud.

iv Select bank regulatory issues applicable to structured products

On 15 December 2016, the Federal Reserve released its final rule on total loss-absorbing capacity (TLAC) and eligible long-term debt (LTD) securities (the Final Rule). The Final Rule requires the top-tier holding company of each US global systemically important banking organisation (each a covered BHC) to maintain certain minimum amounts of external eligible TLAC (consisting, essentially, of regulatory capital and eligible LTD securities) and external eligible LTD securities.

In addition, according to the clean holding company requirements in the Final Rule, a covered BHC is prohibited from directly incurring certain liabilities, including short-term debt and parent guarantees of subsidiary liabilities with certain impermissible cross-defaults.

The clean holding company requirements also impose a cap on unrelated liabilities of a covered BHC at 5 per cent of its external TLAC. Unrelated liabilities generally include, among other non-contingent liabilities, any LTD securities issued by a covered BHC to third parties that are excluded from eligible LTD securities. Importantly, structured notes are excluded from eligible LTD securities. As a result, they do not count towards a covered BHC's minimum external TLAC or LTD requirements and instead are treated as unrelated liabilities that are subject to the 5 per cent cap.

The Final Rule defines structured note as a debt instrument that:

- (1) Has a principal amount, redemption amount, or stated maturity that is subject to reduction based on the performance of any asset, entity, index, or embedded derivative or similar embedded feature;*
- (2) Has an embedded derivative or similar embedded feature that is linked to one or more equity securities, commodities, assets, or entities;*
- (3) Does not specify a minimum principal amount that becomes due upon acceleration or early termination; or*
- (4) Is not classified as debt under GAAP, provided that an instrument is not a structured note solely because it is one or both of the following:*
 - (i) An instrument that is not denominated in U.S. dollars; or*
 - (ii) An instrument where interest payments are based on an interest rate index.*

This definition clearly includes, for example, structured notes where the payment at maturity is based on the performance of one or more equities, commodities or other assets. In other cases, the analysis may be more complex and will depend heavily on the specific structure.

Another area of bank regulation that has affected structured products has been the QFC Stay Rules. These Rules were designed to improve the resolvability and resilience of US global systemically important banking organisations (G-SIBs), including their subsidiaries and branches worldwide, and the US subsidiaries, US branches and US agencies of foreign G-SIBs (covered entities), by mitigating the risk of destabilising closeouts of qualified financial contracts (QFCs) in the event of a covered entity's entry into insolvency or resolution proceedings. QFCs include derivatives, repos, securities lending agreements, and contracts for the purchase and sale of a security, among other contracts. The definition of QFC can pick up structured products in certain instances.

The QFC Stay Rules only apply to 'in-scope' QFCs: that is, QFCs that expressly include a default right⁷ against a covered entity or expressly restrict the transfer of the QFC (or any interest in or under or any property securing the QFC) from a covered entity. The QFC Stay Rules include two substantive requirements:

- a* a requirement that an in-scope QFC expressly recognises the FDIC's power to stay the exercise of certain default rights and transfer the QFC under the Federal Deposit Insurance Act and Title II of the Dodd-Frank Act (Express Recognition Requirement); and

⁷ The QFC Stay Rules define default right extremely broadly to include, among other things, a right of a party under an agreement to liquidate, terminate, cancel, rescind or accelerate an agreement or transactions thereunder, set off or net amounts owed, exercise remedies in respect of collateral or other credit support, demand payment or delivery, or suspend, delay or defer payment or performance thereunder.

- b* a requirement to expressly override certain cross-default rights against a covered entity and provisions restricting the transfer of an affiliate credit enhancement upon an affiliate of the covered entity party entering any insolvency or resolution proceedings (Override Requirement).

While structured products were not the focus of these rules, the rules were drafted such that structured products were captured in certain cases. Issuers were required to review carefully their structured product portfolio to determine whether they included QFCs and, if so, whether any of the QFCs included provisions bringing them in scope for the rules.

The QFC Stay Rules also include a number of exemptions: for example, certain in-scope QFCs governed by US law, and where all non-covered entity parties are US entities are exempted from the Express Recognition Requirement. In-scope QFCs that do not include cross-default rights against a covered entity and that do not restrict the transfer of an affiliate credit enhancement are exempted from the Override Requirement. Even if a structured product is an in-scope QFC, it has to be further analysed to determine whether an exemption is available, depending upon the specific terms of and parties to each agreement.

These rules are another example of the complex interplay between bank regulatory regimes and the sophisticated capital markets transactions that financial institutions perform.

v The enforcement environment

Structured products, especially those offered and sold to retail investors, have faced and will continue to face a very high level of regulatory and media scrutiny in the United States. This includes scrutiny in the form of enforcement actions by the SEC and FINRA.

The SEC is committed to policing all parts of the US capital markets and periodically reviews filings related to offerings of structured products. In recent years, it has brought a number of enforcement actions related to structured products with a focus on both sales practice and disclosure issues. The SEC's Enforcement Division has a special Complex Financial Instruments Unit, which includes former industry participants.

One example of an enforcement action involving the Complex Financial Instruments Unit concerned information about potential offerings (essentially, the embedded options from the investor's perspective) being shared between a structuring desk and potential issuers, but not included in internal education materials for financial advisers. The SEC found that the relevant supervisory policies and procedures were not reasonably designed and implemented to provide effective oversight of the training, education and recommendations of the registered representatives to prevent and detect violations of the Securities Act. This action has led market participants to focus even more heavily on whether, where information about structuring an offering (such as how the underlying reference asset is selected) is shared internally between business units or with issuers, that same information should be included in training materials prepared for financial advisers (and, potentially, shared with investors through the disclosure).

Other cases have concerned failures to adequately disclose hedging and embedded index fees that could negatively impact the value of an underlying index. These cases have further highlighted the importance of clear disclosure regarding trading strategies that underlie indices, as well as the importance of clear disclosure that sets out all of the costs and fees included in indices, including the effect of such costs and fees.

FINRA has also focused much of its recent attention on sales practice risks. Its 2021 Report on FINRA's Examination and Risk Monitoring Program, which is designed to

inform member firms' compliance programmes by providing insights from FINRA's ongoing regulatory operations, highlighted communications, product recommendations and sales practice conduct (especially in the context of protecting senior and vulnerable investors), as well as disclosure for structured notes, as specific areas of focus.

The US regulators' focus on enforcement spans changes in administrations, and so is likely bipartisan.

vi The impact of international law and regulation

Outside of laws and regulations governing securities offerings generally, the main area where international developments have affected offerings of structured products in the United States has been in the sphere of benchmarks regulation. In 2013, the International Organization of Securities Commissions published its Principles for Financial Benchmarks: Final Report (the Principles), which seek 'to create an overarching framework of Principles for Benchmarks used in financial markets'⁸ covering governance and accountability, as well as the quality and transparency of benchmark design and methodologies. Under the Principles, the term benchmark is defined very broadly and includes, among other things, the types of indices often used as underlying reference assets for structured products. While the Principles are not binding, they have been highly influential. As a governance matter and in light of market expectations, many administrators of these types of indices (including proprietary indices) have undertaken audits and published public attestations or compliance statements disclosing the extent of their compliance with the Principles.

In relation to this, the EU Benchmarks Regulation (BMR) has established an EU regulatory framework for benchmarks, including requirements related to benchmark integrity and reliability, transparency and consumer protection, and the authorisation, registration and supervision of administrators. As is the case under the Principles, the term benchmark under the BMR is defined very broadly. In addition to imposing requirements on EU benchmark administrators, the BMR imposes requirements on third-country (i.e., non-EU) administrators by providing that, from January 2022, EU financial institutions will only be able to use a benchmark produced by a third-country administrator (such as a US administrator) in the EU if:

- a* the European Commission has adopted an equivalence decision recognising the regulatory framework in the applicable third country as equivalent to the requirements of the BMR;
- b* the third-country administrator is recognised under the BMR; or
- c* the benchmark has been endorsed by an EU financial institution.

As a result, US entities that create indices that will be used on a global basis (e.g., as an underlying reference asset for structured products sold to investors in the EU) have had to consider the requirements of the BMR in creating these indices, in addition to having to engage with regulators in the EU (e.g., in seeking recognition) so that these indices may be used beyond 2021.

⁸ International Organization of Securities Commissions, 'Principles for Financial Benchmarks: Final Report': <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf> (accessed 31 July 2019).

vii Recent developments affecting underlying reference assets

Two recent regulatory developments have affected underlying reference assets, including the disclosure about such assets that issuers have provided for new issuances.

First, the Holding Foreign Companies Accountable Act (HFCAA) requires the SEC to identify each company that is required to file periodic reports with the SEC that has retained a registered public accounting firm that (1) is located in a foreign jurisdiction; and (2) the Public Company Accounting Oversight Board (PCAOB) is unable to inspect or investigate due to a position taken by an authority in the foreign jurisdiction. If the SEC determines that the PCAOB has been unable to inspect or investigate the accounting firm for three consecutive years, it will prohibit the covered company from trading its securities on a US securities exchange or in any 'over-the-counter' exchange in the US. The SEC will end a prohibition on trading if the covered company certifies to the SEC that it has retained a registered public accounting firm that the PCAOB has inspected to the satisfaction of the SEC. Some issuers have begun including disclosure in structured products linked to US-listed American depositary shares of China-based companies about potential delisting under the HFCAA.

Second, on 3 June 2021, President Biden signed Executive Order 14032, which refined and replaced President Trump's executive order concerning companies with ties to the Chinese military, with a delayed effective date of 2 August 2021 and a delayed divestment date of 3 June 2022. Executive Order 14032 prohibits US persons from engaging in the purchase or sale of any publicly traded securities (and derivatives) of certain companies with ties to the Chinese military. It does not prohibit US persons from possessing securities covered by the order following the conclusion of the 365-day divestment period, though any sale of these securities after that date would require authorisation from the Office of Foreign Assets Control. The definition of 'publicly traded securities' is broad and encompasses securities that trade 'over-the-counter', as well as on a securities exchange. Some issuers have begun including disclosure in structured products linked to Chinese underlying reference assets about these recent executive orders, as well as more generic disclosure about the potential impact of governmental regulatory actions, such as sanctions, in structured products linked to other non-US underlying reference assets.

III OFFERING PROCESS AND POST-SALE REQUIREMENTS

i Offerings and distribution

The key players in the structured product markets include issuers who design and issue the structured products and distributors who market and sell the structured products to end investors. Issuers may distribute structured products through their affiliated broker-dealers or financial advisers or through third-party distribution channels, including private banks, retail distributors and independent asset managers.

A number of web-based multi-issuer distribution platforms, such as SIMON, Halo and Luma, have been launched in recent years to provide an open marketplace for broker-dealers and financial advisers to analyse, trade and monitor structured products for their clients. Some platforms use risk analysis tools and models developed by structured product issuers or other technology providers. These online distribution platforms provide broker-dealers and financial advisers easy access to a broad range of structured products and tools to more easily identify, compare and select the right product. By automating many of the processes involved with structured product offerings, these platforms are expected to simplify how structured

products are created, distributed and managed over the entire life cycle and lower the notional amounts required for structured product issuances. These online distribution platforms may help issuers further expand the structured products market in the United States.

The SIMON platform is operated by SIMON Markets LLC, headquartered in New York City. SIMON is designed to provide educational contents, analytics and life cycle management tools to financial advisers to help them serve their clients' investment needs. Originally developed by Goldman Sachs, it became an independent online platform in December 2018 through equity investments by a group of structured product issuers including Barclays, Credit Suisse, HSBC, JP Morgan and Wells Fargo.⁹

Like SIMON, the Halo platform was developed to change the way structured products are purchased, accessed and traded.¹⁰ Halo runs a competitive auction process for live trades, promoting transparency, price competition and trade execution, and provides independent secondary market liquidity. Halo aims to help both issuers and distributors improve their order management workflow and assist in making back office and product compliance more efficient.

The Luma platform, developed by Zuma Financial Technologies, is a joint venture formed by Navian Capital, Bank of America Merrill Lynch and Morgan Stanley.¹¹ Luma is focused on workflow automation, post-trade position monitoring and comprehensive education, training and compliance management. Luma allows distributors to design and price custom structures across all issuers and track all bids in one place.

Communications with broker-dealers and financial advisers over these online distribution platforms, including dissemination of marketing pieces relating to offerings of structured products as well as more generic educational videos and interactive tools, will pose questions for issuers, distributors and platform operators as to whether any of such communications should be deemed to constitute an 'offer' as that term is defined under the Securities Act, and whether such communications will be subject to FINRA filing, review and approval as described below.

ii Sales and marketing

As noted above, FINRA is a self-regulatory organisation dedicated to investor protection and market integrity through regulation of registered broker-dealers. Because most structured products are sold by registered broker-dealers, offerings and sales of these structured notes need to comply with FINRA regulations. In recent years, FINRA and the SEC have been heavily focused on structured products, including sales practice, investor communications and conflicts of interest.

9 See SIMON Markets LLC, 'SIMON Expands Structured Investment Platform with Six New Investors' (press release dated 10 December 2018).

10 See Halo Investing, 'Halo Investing Raises Series B Funding for Global Expansion of Structured Notes Platform' (press release dated 6 June 2019).

11 See Luma Financial Technologies, 'Navian Capital, Bank of America Merrill Lynch and Morgan Stanley Launch Open Architecture Online Platform for Structured Products and Annuities' (press release dated 31 July 2018).

Know your customer and suitability

A key concern raised by the SEC and FINRA was the mis-selling of structured products by distributors. The purpose of the know your customer and suitability obligations under FINRA Rules 2090 and 2111 is to ensure robust investor protection and promote fair dealing and ethical sales practices.

FINRA Rule 2090 (Know Your Customer) requires firms to use reasonable diligence, in regard to the opening and maintenance of every account, and to know the essential facts concerning every customer.¹² The know-your-customer obligation arises at the beginning of the customer–broker relationship and does not depend on whether the broker-dealer has made a recommendation.

FINRA describes suitability obligations as ‘critical to ensuring investor protection and promoting fair dealings with customers and ethical sales practices’.¹³ FINRA Rule 2111 (Suitability) requires that a member have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member to ascertain the customer’s investment profile.¹⁴ The rule provides that a customer’s investment profile ‘includes, but is not limited to, the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs [and] risk tolerance’, along with other information. FINRA Rule 2111 contemplates three main suitability obligations:

- a* reasonable basis suitability: a broker-dealer must perform reasonable diligence to understand the nature of the recommended security or investment strategy involving a security or securities, as well as the potential risks and rewards, and determine whether the recommendation is suitable for at least some investors based on that understanding;
- b* customer-specific suitability: a broker-dealer must have a reasonable basis to believe that a recommendation of a security or investment strategy involving a security or securities is suitable for the particular customer based on the customer’s investment profile; and
- c* quantitative suitability: a broker-dealer who has control over a customer account must have a reasonable basis to believe that a series of recommended securities transactions, taken together, are not excessive. Quantitative suitability was FINRA’s attempt to codify its position against excessive trading.

On 5 June 2019, the SEC adopted Regulation Best Interest under the Securities Exchange Act of 1934 (the Exchange Act). Regulation Best Interest establishes a ‘best interest’ standard of conduct for broker-dealers and associated persons, when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities.¹⁵ Among other things, Regulation Best Interest incorporates and enhances principles that are

¹² See FINRA Regulatory Notice 11-02.

¹³ Financial Industry Regulatory Authority, Inc, ‘Suitability’: <https://www.finra.org/industry/suitability> (accessed 31 July 2019).

¹⁴ See FINRA Regulatory Notices 12-55, 12-25 and 11-25.

¹⁵ See US Securities and Exchange Commission, ‘SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships With Financial Professionals’ (press release dated 5 June 2019) and SEC release No. 34-86031 dated 5 June 2019.

also found in FINRA Rule 2111 (Suitability). To provide clarity over which standard applies, FINRA has amended its suitability rule on 30 June 2020 to clarify that Rule 2111 does not apply to recommendations that are subject to Regulation Best Interest.¹⁶

Investor communications

FINRA Rule 2210 governs investor communications by registered broker-dealers and associated persons. The Rule sets forth requirements for content, approval, review, recordkeeping and filing of communications with FINRA.

FINRA Rule 2210 defines three categories of communications:

- a* retail communication: any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period. A retail investor is any person other than an institutional investor, regardless of whether the person has an account with the firm;
- b* correspondence: any written (including electronic) communication distributed or made available to 25 or fewer retail investors within any 30 calendar-day period; and
- c* institutional communication: any written (including electronic) communication that is distributed or made available only to institutional investors but does not include a firm's internal communications. Institutional investors include various financial institutions, government entities, FINRA members, registered investment advisers, and a person or entity with assets of at least US\$50 million.¹⁷

Unless an exclusion applies, retail communications concerning any registered structured products must be filed with FINRA's Advertising Regulation Department within 10 business days of first use or publication. Prospectuses, preliminary prospectuses, offering circulars, free writing prospectuses and similar documents that have been filed with the SEC or any state and similar offering documents concerning securities offerings that are exempt from SEC and state registration requirements are exempted from the filing requirements.

An appropriately qualified registered principal must approve each retail communication before the earlier of use or filing with FINRA. A broker-dealer must establish appropriate written procedures for the review of institutional communications by an appropriately qualified registered principal.

In addition, pursuant to FINRA Rule 2210 and related FINRA guidance:

- a* communications must be based on principles of fair dealing and good faith, be fair and balanced and provide a sound basis for evaluating the facts;
- b* no member may make any false or misleading statement or claim in any communication or publish, circulate or distribute any communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading;
- c* members must ensure that statements are clear and not misleading within the context in which they are made and that they provide balanced treatment of risks and potential benefits; and

16 See FINRA Regulatory Notice 20-18.

17 Financial Industry Regulatory Authority, Inc, 'What and When to File with Advertising Regulation': <https://www.finra.org/rules-guidance/key-topics/advertising-regulation/chart> (accessed 10 September 2019).

- d* backtested data (e.g., hypothetical retrospective simulation data for an index) is generally prohibited.

Regulation Best Interest

As noted above, the SEC adopted Regulation Best Interest on 5 June 2019, which imposes a new standard of conduct for registered broker-dealers that will enhance the standard of conduct beyond the existing suitability obligations imposed by FINRA regulations. Regulation Best Interest became effective on 30 June 2020.

Specifically, Regulation Best Interest requires that a broker-dealer and its associated persons who are natural persons when making a recommendation, including a recommendation of structured products, must act in the retail customer's best interest and not place its own interests ahead of the customer's interests. To satisfy this best interest obligation, a broker-dealer must satisfy each and every one of the following four component obligations:

- a* disclosure obligation: a broker-dealer, before or at the time of the recommendation, must provide the retail customer, in writing, full and fair disclosure of all material facts as to the scope and terms of its relationship with the retail customer and all material facts relating to conflicts of interest that are associated with a recommendation;
- b* care obligation: a broker-dealer must exercise reasonable diligence, care and skill in making the recommendation. The care obligation is modelled after the concepts of reasonable-basis suitability, customer-specific suitability and quantitative suitability, but under a higher best interest conduct standard than the existing requirements under FINRA regulations;
- c* conflict of interest obligation: a broker-dealer must establish, maintain and enforce policies and procedures reasonably designed to identify, monitor and mitigate (or eliminate, if possible) conflicts of interest; and
- d* compliance obligation: a broker-dealer must establish, maintain and enforce policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

The SEC does not define best interest. Instead, whether a broker-dealer has acted in a retail customer's best interest is based on an objective assessment of the facts and circumstances of how the broker-dealer has satisfied the four component obligations of Regulation Best Interest at the time the recommendation is made. The best interest standard does not necessarily obligate a broker-dealer to recommend the least expensive security or investment strategy, so long as the broker-dealer can show that it satisfies the four component obligations of Regulation Best Interest.

Regulation Best Interest only applies when a broker-dealer makes a recommendation to a retail customer, which is defined as a natural person, or the legal representative of such person, who receives a recommendation for any securities transaction or investment strategy and uses the recommendation primarily for personal, family or household purposes. Unlike the FINRA definition of retail investor, the term retail customer includes only natural persons acting for personal, family or household purposes, regardless of wealth or sophistication. In addition, Regulation Best Interest will not apply when the natural person is represented by professional representatives such as broker-dealers, registered investment advisers or other similar fiduciaries. Therefore, distributors who sell structured products directly to broker-dealers or registered investment advisers, rather than retail customers, will not be subject to Regulation Best Interest.

The SEC explicitly stated that it does not intend for Regulation Best Interest to create a new private right of action. Under certain circumstances, Regulation Best Interest may provide, however, a new basis for investors to bring claims of fraud against broker-dealers. To protect investors, broker-dealers are not permitted to contract out of Regulation Best Interest.

Shortly after Regulation Best Interest was adopted, the attorneys general of seven states and the District of Columbia and an organisation of investment advisers initiated litigation against the SEC seeking to strike down Regulation Best Interest on the grounds that the SEC exceeded its statutory authority under the Dodd-Frank Act. The 2nd US Circuit Court of Appeals upheld Regulation Best Interest in a unanimous decision in June 2020 by finding that the Dodd-Frank Act grants the SEC broad rulemaking authority, and Regulation Best Interest falls within the discretion granted to the SEC by Congress.

At the state level, legislators and regulators in several states are working towards imposing fiduciary duties and more stringent broker-dealer conduct standard. The SEC does not affirm in the final release that the Regulation Best Interest would pre-empt any standards under state law that are inconsistent with SEC regulation. Instead, the SEC states that the pre-emptive effect of Regulation Best Interest on any state law governing the relationship between broker-dealers or investment advisers and their customers would be determined in future judicial proceedings based on the specific language and effect of that state's law.

DOL Fiduciary Rule

Beyond the suitability obligations imposed by FINRA regulations and the best interest obligation imposed by Regulation Best Interest, structured products sales practices where parties provide investment advice with respect to assets of employee plans or individual retirement accounts (IRAs) may also be subject to the fiduciary obligation imposed by the US Department of Labor (DOL) Fiduciary Rule under the Employee Retirement Income Security Act of 1974.

From its original form dating back to 1975, the DOL Fiduciary Rule has changed over time amidst an evolving regulatory landscape and interest in investor protection. In 1975, the DOL first promulgated a definition of 'investment advice' for the purposes of determining when financial institutions and their investment professionals would be viewed as providing fiduciary investment advice with respect to assets of employee plans or IRAs (the Original Fiduciary Rule). Pursuant to the Original Fiduciary Rule, a party would be viewed as providing fiduciary investment advice only upon the satisfaction of all five elements of the following test, which required that the advice:

- a* pertain to the purchase, sale or value of securities or other property;
- b* be provided on a regular basis;
- c* be provided pursuant to a mutual agreement, arrangement or understanding between the provider of the advice and the plan, plan fiduciary or IRA owner;
- d* would, pursuant to the mutual understanding, serve as a primary basis for investment decisions with respect to assets of the plan or IRA; and
- e* would be individualised to the particular needs of the plan or IRA.

In 1996, the DOL issued an Interpretive Bulletin that clarified that the provision of various forms of investment education materials and tools to assist individuals in the investment and management of their retirement assets would not constitute the provision of fiduciary investment advice (Investment Education Bulletin). The Investment Education Bulletin acted as a carve-out to the Original Fiduciary Rule.

Decades later, in 2016, the DOL adopted revised rules that significantly broadened the circumstances in which parties would be viewed as providing fiduciary investment advice and also repealed the Investment Education Bulletin (the 2016 Fiduciary Rule). The 2016 Fiduciary Rule was accompanied by two new prohibited transaction class exemptions, the best interest contract exemption and the principal transactions exemption, which were intended to assist financial institutions and their investment professionals navigate the broadened definition of ‘investment advice’. However, the 2016 Fiduciary Rule was challenged by various financial industry groups, including broker-dealers who were concerned that the 2016 Fiduciary Rule could discourage the sale of commission-based structured products through retirement channels. In March 2018, the Fifth Circuit vacated the 2016 Fiduciary Rule and its related exemptions, concluding that the DOL had overreached its authority and acted in an arbitrary and capricious manner in violation of the Administrative Procedure Act. Subsequently, in June 2018, the Fifth Circuit issued a mandate, making its opinion effective and returning the entire regime to the status quo of the Original Fiduciary Rule. In the interim, the two related exemptions were preserved by the DOL in May 2018 through a Field Assistance Bulletin meant to accommodate financial institutions that had already devoted significant resources to complying with such exemptions and that might prefer to continue relying on them.

Then, in June 2020, the DOL proposed formally reinstating the Original Fiduciary Rule and also proposed a new prohibited transaction class exemption. Accordingly, on 18 December 2020, the DOL issued a final rule (the 2020 Fiduciary Rule) that went effective on 16 February 2021. The 2020 Fiduciary Rule not only reinstated the Original Fiduciary Rule, but did so in a way that modestly reinterpreted the Original Fiduciary Rule’s five-part test. The 2020 Fiduciary Rule provides new guidance on rollover advice and other matters. In addition, the new prohibited transaction class exemption (PTE 2020-02) permits financial services companies to: (1) receive compensation while acting as investment advice fiduciaries, including in connection with offering advice on individual retirement account rollovers; and (2) execute ‘riskless’ and certain other principal trades for retirement assets to which they act as investment advisers, if the fiduciaries comply with ‘impartial conduct’ standards and satisfy certain other requirements. Although the current administration allowed the 2020 Fiduciary Rule to go effective, the DOL may propose yet another iteration. According to its Spring 2021 Regulatory Agenda, the DOL plans to rewrite the definition of ‘fiduciary,’ with the notice of rule-making expected to be issued by December 2021.

iii New product approval and post-sale review

Published in October 2013, the stated objective of FINRA’s Report on Conflicts of Interest (Conflicts Report) was to focus on firms’ approaches to identifying and managing conflicts in three critical areas: firms’ enterprise-level frameworks to identify and manage conflicts of interest; approaches to handling conflicts of interest in manufacturing and distributing new financial products; and approaches to compensating their associated persons, particularly those acting as brokers for private clients.

The Conflicts Report specifically addresses broker-dealers’ obligations in identifying and managing conflicts in manufacturing and distributing new structured products. The key practical takeaway from the Conflicts Report for structured products is the need for firms to be on the lookout for situations in which they or one of their affiliates plays a role in connection with an offering that may give rise to potential conflicts, for example, acting as an index sponsor or calculation agent, and consider how to minimise and appropriately disclose

any such potential conflict. The Conflicts Report noted a number of effective practices issuers and broker-dealers can adopt to address the conflicts of interest that a new product may present, including using new product review committees to identify and mitigate conflicts and performing post-launch reviews of new products to identify potential problems with a product that may not have been readily apparent during the initial review.

Historically, most issuers of structured products in the United States relied on one or more of their affiliated broker-dealers to distribute their products. More recently, the open architecture model has become more prevalent. Under this model, broker-dealers that are not affiliated with the issuer may distribute the issuer's products. Among other things, this model allows broker-dealers to offer their clients structured products issued by a number of different issuers, thereby avoiding giving their clients concentrated exposure to the credit risk of one issuer or a small number of issuers. The open architecture model is also particularly important for foreign issuers that may not have a sales force in the United States to assist in distributing their products.

The Conflicts Report encouraged issuers, as product manufacturers, to take responsibility for how products, particularly complex products, are distributed to investors by implementing effective KYD policies to assess potential distributors' sales practices, marketing strategies, registered representative training, investor education, compliance culture and customer base. Market participants use KYD policies and procedures to assess potential distributors of structured and complex products, which FINRA says helps 'mitigate the incentive to increase revenue from product sales by using distribution channels that may not have adequate controls to protect customers' interests'.¹⁸ According to FINRA in the Conflicts Report, effective KYD practices include:

- a* conducting background checks on the distributor and relevant employees;
- b* reviewing the financial soundness of the distributor;
- c* requiring distributors to complete a detailed questionnaire to help the manufacturer assess a distributor's sales practices, marketing strategy, registered representative training, investor education, compliance culture, product classification, trade review and sign-off process and distribution strength;
- d* interviewing a distributor to develop an understanding of the firm's:
 - compliance culture;
 - experience, particularly with more complex products; and
 - capability and willingness effectively to discharge its suitability obligations;
- e* obtaining information about a distributor's customer base;
- f* reviewing a distributor's relevant compliance manuals, written supervisory procedures and other relevant materials;
- g* reviewing and approving the distributor through a cross-functional committee;
- h* reviewing sub-distributors and sub-dealers annually; and
- i* requiring distributors and sub-distributors to sign an agreement committing to ensure adherence to the relevant rules and regulations (such as suitability and due diligence).

FINRA's guidance with respect to complex products is discussed in Section VI.ii.

18 Financial Industry Regulatory Authority, Inc, 'Report on Conflicts of Interest': <https://www.finra.org/sites/default/files/Industry/p359971.pdf> (accessed 31 July 2019).

IV EXCHANGE LISTING AND TRADING

i Exchange-traded notes generally

Exchange-traded notes (ETNs) raise special legal and regulatory considerations in the United States. The term ETNs is commonly used to refer to exchange-listed notes that are linked to an underlying index or asset, offered on a continuous basis and subject to daily or weekly redemption at the investor's option. These features distinguish notes referred to as ETNs from ordinary debt securities that are listed on an exchange; the latter two features also distinguish ETNs from ordinary structured notes that are listed on an exchange.

ETNs are typically offered on a continuous basis, which means that the issuer or its broker-dealer affiliate continuously stands ready to issue and sell the ETNs to meet market demand. The price at which the issuer or its broker-dealer affiliate would be willing to sell the ETNs is typically based on their indicative value. The indicative value of a series of ETNs is determined in a formulaic manner based on the value of the ETNs' underlying index or asset at the time of determination, and is the amount the issuer would be required to pay on the ETNs if the payment at maturity or upon early redemption were determined at that time. The willingness of the issuer or its broker-dealer affiliate to issue and sell ETNs at their indicative value, combined with the right of an investor to cause the issuer to redeem the ETNs at their indicative value, is expected to ensure (through the creation of arbitrage opportunities) that the trading price of the ETNs on the exchange tracks their indicative value, which the issuer publishes on a real-time basis throughout the trading day. However, the trading price of a series of ETNs on the exchange is determined by supply and demand, and there is no guarantee that their trading price will closely track their indicative value.

ii Disclosure

The unique features of ETNs raise special disclosure considerations. Issuers typically include prominent disclosure about the fact that the indicative value of an ETN is not the same as its trading price on the exchange and that there is no guarantee that an investor will be able to buy or sell the ETNs at their indicative value in the secondary market. Although an investor has the right to cause the issuer to redeem the ETNs at their indicative value, the investor must typically submit at least a specified minimum number of ETNs to exercise that right; an investor owning less than the minimum number must therefore look only to the secondary market for liquidity. ETN prospectuses also typically caution that the issuer may suspend sales of the ETNs at any time, which may cause a premium to develop, and then restart sales, which may cause the premium to collapse.

Market participants sometimes use terminology from the ETF context with respect to ETNs, referring to a new issuance of an ETN as a 'creation' and to the indicative value of an ETN as its 'NAV'. Like ETFs, ETNs offer exposure to an underlying index or asset, with continuous creations and redemptions and the liquidity of an exchange-traded product. Unlike ETFs, however, ETNs do not represent an ownership interest in any underlying assets, but rather are unsecured debt obligations of the issuer. The SEC has advised ETN issuers that their disclosures should avoid using terminology (such as referring to a unit of an ETN as a share) that would suggest that the investor is purchasing an equity interest in an ETF, rather than an unsecured debt security.

iii Leveraged ETNs

Some ETNs offer leveraged exposure to their underlying index or asset. That leverage may be reset daily, monthly or at some other interval. Leveraged ETNs present heightened risks as compared to otherwise similar unleveraged ETNs. Some leveraged ETNs, especially those for which the leverage is reset daily, are not meant to be held for more than one day and may be expected to lose value over time regardless of the directional performance of the underlying index or asset. FINRA has issued a special regulatory notice reminding broker-dealers of their sales practice obligations in connection with leveraged ETNs, including the obligations to ensure that recommendations to customers are suitable and based on a full understanding of the terms and features of the product recommended; that sales materials are fair and accurate; and that adequate supervisory procedures are in place to ensure that these obligations are met. In 2018, the SEC brought an enforcement action against a broker-dealer for unsuitable recommendations of leveraged ETNs that were intended only for short-term trading, but that were sold to investors who incurred significant losses after holding them for an extended period of time.

iv Regulation M

Common terms and practices with respect to ETNs require relief from certain US regulatory requirements, most saliently Regulation M under the Exchange Act. Regulation M is an anti-manipulation regulation that, subject to certain exemptions, prohibits an issuer, distribution participant and their respective affiliated purchasers from bidding for or purchasing any security that is the subject of a distribution until after the completion of the distribution. ETNs are in continuous distribution and, at the same time, are continuously purchased by the issuer or its broker-dealer affiliate. Absent relief or an available exemption, the purchase of the ETNs at a time when they are in distribution would violate Regulation M.

In 2006 and 2007, the staff of the SEC issued a series of no-action letters advising that it would not recommend enforcement action under Regulation M in connection with the ETNs described in those letters. The principal bases for the staff's no-action position were the representations of the issuers that the ETNs were redeemable at the option of the holder on a daily or weekly basis and that the secondary market price of the ETNs should not vary substantially from the value of the relevant underlying indices. At the time of listing a new series of ETNs, the issuer is typically required to affirm to the relevant exchange that the new ETNs comply with these no-action letters, which requires the issuer to determine that the ETNs are substantially similar in relevant respects to the ETNs described in the letters.

v Exchange listing rules

To be listed on a US national securities exchange, an ETN must meet the requirements for listing set forth in the rules of the exchange. Many US national securities exchanges have generic listing standards that permit the listing of an ETN so long as those standards are met. The NYSE Arca, for example, has generic listing standards that permit the listing of notes linked to an equity index, commodity or commodity futures, currency, bond index, certain futures or a combination of those underlyings, subject to the satisfaction of certain criteria generally applicable to the issuer of the ETNs and the ETNs themselves, as well as criteria specific to the ETNs' underlying index or asset.

The NYSE Arca's generally applicable criteria include requirements that:

- a* the issuer of the ETNs meet certain minimum asset and tangible net worth tests and be in compliance with certain corporate governance requirements;

- b* the ETNs be redeemable at the option of the holders on at least a weekly basis, or else have a minimum number of publicly held units, and either have a minimum number of holders or be traded in US\$1,000 denominations;
- c* the ETNs have a minimum principal amount or market value outstanding of US\$4 million;
- d* the ETNs be non-convertible debt securities with a minimum term of one year and a maximum term of 30 years; and
- e* the ETNs may not provide for a loss or negative payment at maturity that is accelerated by a multiple that exceeds three times the performance of the underlying index or asset.

The NYSE Arca's underlying-specific criteria vary depending on the type of underlying index or asset. The criteria for an underlying equity index, for example, relate to the concentration of the index in any single issuer, the market capitalisation and trading liquidity of the component stocks and whether the component issuers are domestic or foreign.

If an ETN does not fall within the generic listing standards of an exchange, the exchange may submit a Rule 19b-4 filing to the SEC, requesting that the SEC approve a new exchange listing rule permitting the listing of the particular ETNs in question.

vi Day 20 formula pricing in cash tender offer for ETNs

A tender offer is an offer, typically made by an issuer, to purchase all or a portion of its outstanding debt or equity securities for consideration that may be cash, securities or a combination of both.¹⁹ Rule 14e-1 under the Exchange Act lays out certain requirements to prevent unlawful tender offer practices. These requirements include, but are not limited to, keeping a tender offer open for at least 20 business days after notice of its commencement and keeping a tender offer open for at least 10 business days after notice of an increase or decrease in the consideration offered. In addition, Section 14(e) of the Exchange Act prohibits any person from omitting to state any material fact necessary in order to make the statements made in connection with a tender offer, in light of the circumstances under which they were made, not misleading.

However, tender offers of structured products (including ETNs) raise unique pricing issues. For instance, using a fixed purchase price announced at the commencement of the tender offer or revised at least 10 business days before the expiration of such tender offer (Day 10 pricing) would not be consistent with the valuation method for structured products, whose values may fluctuate wildly based on the performance of the underlying assets on the relevant trading day. Accordingly, Day 10 pricing would not capture any increase or decrease in the levels of the underlying assets in the last 10 business days of the tender offer, and the issuer would need to increase the purchase price to induce holders to tender or decrease the purchase price to avoid overpaying. Such adjustments to the purchase price would require multiple extensions of the tender offer, making it extremely difficult to complete the tender offer in a short period of time.

The SEC considered a similar pricing issue for cash tender offers of convertible debt securities and has granted no-action relief since 2009 to allow issuers of convertible debt securities to determine the purchase price on the expiration date of the tender offer (Day 20

¹⁹ The term 'tender offer' has not been defined in any SEC Rule or other statutory provision. The staff of the SEC and the courts consider various factors to make such determination. The definition provided above is a general one for purposes of the subsequent discussion.

pricing).²⁰ Such no-action relief with respect to Day 20 pricing was recently expanded to apply to ETNs. On 28 May 2020, the staff of the SEC granted no-action relief to Barclays Bank PLC (Barclays) with respect to a proposed cash tender offer to purchase its outstanding iPath® MSCI India Index ETNs (India ETNs) for a purchase price to be determined on the expiration date of the tender offer, calculated in a formulaic manner based on the closing level of the underlying index on such expiration date.²¹ The incoming letter to the SEC argued that because Barclays would announce the actual pricing formula upon the commencement of the tender offer and describe the precise manner in which the purchase price would be calculated in the offering memorandum, the proposed tender offer would not violate Rule 14e-1(b) or Section 14(e) under the Exchange Act. In addition, the letter reasoned that holders of the India ETNs would expect to receive a purchase price determined using the same valuation method for the India ETNs at maturity or upon early redemption by referencing the closing level of the underlying index on the relevant trading day, and therefore, it would be appropriate to calculate the purchase price in a manner consistent with the single-trading-day valuation method at maturity or upon early redemption of the India ETNs.

In light of the SEC's grant of no-action relief to Barclays with respect to the India ETNs, those contemplating tender offers of ETNs or other structured products need not be bound by the impracticality of Day 10 pricing. Instead, with such precedent in place, greater pricing flexibility for structured products may be possible in cash tender offers within the confines of the overall regulatory scheme.

vii Recent enforcement action

In May 2021, the SEC announced a settled enforcement action against an index provider in connection with an index it had licensed for use as an underlier for certain ETNs. The SEC alleged that the index provider failed to disclose that the index in question contained an 'auto hold' feature, a quality control feature pursuant to which its real-time calculation would be suspended during times of extreme volatility. In February 2018, the index in question experienced a high degree of volatility, triggering the 'auto hold' and resulting in a temporary freezing of the index level at a level that did not represent the real-time value that would have been calculated absent the 'auto hold'. According to the SEC, because the 'auto hold' was not disclosed, investors buying and selling the linked ETNs were not aware that the published index level was not accurate. In announcing this action, the SEC stated that an index provider that licenses an index for use in the issuance of securities has an obligation to ensure that disclosures about the important features of the index are materially accurate.

V TAX CONSIDERATIONS

i General overview

The US taxation of structured products is a grey area built on a skeletal framework of statutes and case law, fleshed out only in part by regulations and other regulatory guidance. Although the framework and regulatory authorities establish certain basic principles regarding the

20 See, for example, the letters for Thermo Fisher Scientific Inc. (13 November 2009), Textron, Inc. (7 October 2011), CNO Financial Group, Inc. (11 February 2013), Group 1 Automotive, Inc. (16 May 2014) and GenCorp Inc. (19 December 2014).

21 See the letter for Barclays Bank PLC (28 May 2020).

treatment of structured products generally and address the treatment of certain products with a higher level of detail, the Internal Revenue Service (IRS) has not issued tailored guidance on the tax treatment of many of the structured products most commonly offered. Because of the lack of certainty concerning the proper treatment of many popular products, tax practice in the area is frequently characterised by careful analysis of the economics of a particular structure and rigorous analogy to the most similar financial instruments for which there is clear treatment under the law. In ambiguous cases, practitioners commonly tend towards more conservative treatments that are less likely to be challenged by the IRS, especially in light of the fact that many issuances require an opinion of tax counsel as to their treatment.

For US investors, the fact that there will be a recognition event at some point during the term of the investment, at which time income, gain or loss will be recognised, is a foregone conclusion with respect to most investments. Thus, the critical tax issues for US investors are the timing and character of income, gain, loss or deduction. US investors generally will prefer not to recognise gain until maturity (or until disposition, if they dispose of the instrument prior to maturity) and will prefer to recognise long-term capital gain rather than ordinary income. The benefits of capital versus ordinary treatment are twofold. First, capital losses can only be used to offset income other than capital gain in limited circumstances. Therefore, taxpayers with capital losses generally prefer that their gains be capital to allow them to utilise the capital losses. Second, for individual taxpayers, long-term capital gains are taxed on the federal level at a lower rate (currently, at a maximum rate of 20 per cent) than ordinary income (currently, at a maximum rate of 37 per cent). Thus, the tax impact to a US investor can differ significantly depending on whether the structure allows for deferral and whether tax items in respect of the investment are ordinary or capital.

For a non-US investor, the primary focus from a US tax standpoint is whether the investor will be subject to US withholding on payments received pursuant to the investment (assuming the income or gain from the investment is not effectively connected with a US trade or business conducted by the investor) or whether it can benefit from an exemption due to the characterisation of the particular type of payment in question. This will be a gating question for many non-US investors who will not consider investing in an instrument that will result in US tax. Hence, the tax characterisation of a particular structured product is of critical importance for a non-US investor as well.

ii Distinction between debt and non-debt

Debt

The tax analysis of any structured product begins with the question of whether the product is treated as debt for tax purposes. Surprisingly, there is no general statutory or regulatory definition of what constitutes debt; the governing framework is rather a nebulous body of case law and IRS guidance. Under this framework, the most prominent feature of a debt instrument is an investor's right to receive a fixed amount of money roughly equal to the investor's initial investment at some definite point in the foreseeable future, commonly referred to as principal protection. Regular coupon payments, limited upside participation in the issuer, creditor enforcement rights and a lack of voting rights are other significant identifying features of debt. For many structured products, however, the deciding, and often sole, debt-like feature is the existence of principal protection with concomitant creditor rights. However, the threshold percentage of the principal amount that needs to be protected in order for an instrument to be considered debt is unclear. Market practice is generally to treat anything that is at least 90 per cent principal protected as debt. Notes with less

than 80 per cent protection descend into an ambiguous netherworld in which practitioners often conclude that they cannot provide much comfort that an instrument will be respected as debt.

If an instrument is treated as debt, then a US investor is required to recognise ordinary interest income throughout the term of the instrument, and the issuer will generally be able to take interest deductions (subject to certain exceptions beyond the scope of this publication). Any stated interest on a debt instrument that is payable at least annually at a single fixed rate (qualified stated interest) generally is taxable to a US investor at the time it accrues or is received, in accordance with the US investor's method of accounting for US tax purposes. If a debt instrument provides for any stated interest that does not meet the requirements described above or the debt instrument is issued at a discount, the excess of the total payments on the instrument that are not qualified stated interest over the issue price of the instrument is treated as accruing over the term of the instrument for tax purposes (subject to a *de minimis* exception). This excess is included in income by a US investor as original issue discount (OID) as it accrues, in accordance with a constant-yield method based on a compounding of interest. When a note is publicly traded and is subject to OID accrual, the issuer will file an IRS Form 8281 to inform the IRS that the note is subject to accrual of OID. The IRS periodically publishes a list of notes with OID and their required accruals online.

Subject to the discussion below concerning contingent payment debt instruments (CPDIs), gain or loss recognised by a US investor on the sale or other taxable disposition of an instrument treated as debt generally is treated as capital gain or loss and generally is long-term capital gain or loss if at the time of the sale or other taxable disposition the instrument has been held by the US investor for more than one year.

Debt instruments that provide for a variable rate of interest are subject to special rules. If the instrument provides for payment of interest at least annually at one or more floating rates that can be reasonably expected to measure variations in the cost of borrowing in the currency instrument's denomination (a qualified floating rate), an objective rate that uses a single, fixed formula based on objective economic information (an objective rate), or a combination of a single fixed rate and one or more qualified floating rates, it will generally be treated as a variable rate debt instrument (VRDI). VRDIs are generally subject to the same rules governing OID described above, but OID accruals will also be required when a VRDI provides for payment at two or more rates over its term with sufficient discrepancy between them to result in non-*de minimis* OID.

If an instrument that provides for a variable rate does not qualify as a VRDI, or if an instrument otherwise provides for a contingent payment that is not remote or incidental and is not subject to certain enumerated exceptions in the relevant Treasury regulations, then it generally will be subject to the regulations governing CPDIs. These regulations require accrual of interest income based upon a projected payment schedule, which must produce a yield equal to the issuer's comparable yield (the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the CPDI) and is determined at the time of issuance of the instrument. The rules provide for positive or negative adjustments to the amount of income or deductions attributable to the debt instrument in a taxable year for any differences between projected and actual contingent payments. In addition, any income on the sale, exchange, retirement or other taxable disposition of the instrument is treated as interest income rather than as capital gain. Accordingly, the qualification of a note as a VRDI and not as a CPDI can be particularly important.

Open transactions (non-debt)

Even if it is relatively clear that a structured product is not debt, there remains a question as to what the product is, in fact, for tax purposes. Although perhaps the most familiar contrast to debt is equity, structured products generally do not contain features emblematic of an equity investment. Structured products generally do not provide the investor with any upside or downside economic exposure to the issuer (other than to the issuer's credit risk) or give the investor any governance rights with respect to the issuer. Moreover, structured products have a limited term rather than an indefinite one. Thus, instruments that are not debt most commonly fall into the broader category of what are known as open transactions. Open transactions are transactions where, despite the fact that the taxpayer makes or receives certain upfront payments on the contract (or certain other payments prior to maturity), the taxpayer does not take those payments into account at the time they are received; rather, the total amount of gain or loss with respect to those payments is only calculated when the investment is closed out and final payments are made or received, against which earlier payments are netted to arrive at the total amount of gain or loss. The purchase of a cash-settled option is the quintessential example of an open transaction. Because whether the taxpayer recognises an economic gain or loss on the contract depends on whether, and the extent to which, the amount to be received upon disposition, lapse or settlement is in excess of the premium paid, the taxpayer does not recognise a loss at the time it makes a premium payment. Rather, the recognition event is deferred until the time that the gain or loss on the investment can be more fully ascertained.

While the Internal Revenue Code (the Code) and the regulations promulgated thereunder provide rules explicitly addressing the treatment of certain kinds of open transactions (e.g., certain options and swaps), when an instrument cannot be squeezed into one of these rubrics, the character of the gain or loss at maturity or upon a taxable disposition, and the treatment of any coupons paid under the instrument, is often less clear. However, the Code provides a general framework for the treatment of gain or loss on the termination of a right or obligation that is 'with respect to property which is . . . a capital asset in the hands of the taxpayer'. Under this framework, gain or loss attributable to the cancellation, lapse, expiration or other termination of such a right or obligation is treated as capital gain or loss, and will be long-term capital gain or loss if the instrument was held for more than a year.

Component analysis

To further complicate the topography, there are times at which the most compelling tax treatment of an instrument is to bifurcate the instrument into its component parts and treat each component separately for tax purposes. Structured products are generally constructed from a combination of one or more derivatives and a loan. Although as a general matter, case law and other authorities suggest that components of a derivative that are not economically separable (i.e., cannot trade separately) generally should not be treated as separate instruments for tax purposes, for certain structured products where the view is that bifurcation results in an approach that best mirrors economics, market practice is to separate out these components and treat them as separately taxable.

iii Non-US investors

Certain types of US-source income of non-US investors (that is not effectively connected with the conduct of a trade or business in the United States, which generally results in the non-US investor being subject to US taxation in the same manner as a US investor) are

subject to a withholding tax of 30 per cent of the gross amount paid unless a statutory or treaty-based exception applies. This withholding tax applies to interest, dividends and many other types of income, although it notably does not apply to gains from the sale or exchange of property. In the structured products context, this withholding tax commonly will not apply because:

- a* the income is not US-sourced;
- b* the income qualifies for the portfolio interest exemption (an exception applicable to many interest payments received by non-US investors who are not banks and who do not own a significant interest in the equity of the issuer); or
- c* the income is exempt under a treaty between the non-US investor's home country and the United States.

Non-US investors are required to verify their identity as non-US persons and their eligibility for any applicable treaty benefits in order to qualify for any reductions or exemptions from withholding, and generally do so by providing the relevant IRS Form W-8 to the appropriate payor.

Section 871(m) and dividend equivalents

Prior to the addition of Section 871(m) to the Code, if a non-US investor entered into a derivative transaction with another non-US person that was linked to a US equity, there generally was no US withholding required on any payments on the transaction. Thus, a non-US investor was able to enter into a derivative that replicated the economics of an investment in a US equity and was able to receive the economic equivalent of a dividend from a US company without being subject to withholding. In 2010, Section 871(m) was enacted, and along with the implementing regulations, it restricts such workarounds by assessing a 30 per cent withholding tax (or lower treaty rate) on dividend equivalent amounts paid with respect to transactions that provide non-US investors with economic exposure substantially equivalent to a direct investment in US equities. Special regulatory tests apply for determining whether instruments give rise to dividend equivalents (including a delta test for instruments with simpler payouts under which instruments with a delta of 80 per cent or more are subject to Section 871(m) withholding tax). However, the IRS has clarified that for securities issued before 1 January 2023, this withholding will not apply with respect to most instruments unless the instrument has a delta of one. (Delta is the ratio of the change in the fair market value of the instrument to a small change in the fair market value of the number of shares of the underlying security referenced by the instrument.) Most equity-linked structured products do not have a delta of one and therefore are not currently subject to Section 871(m).

iv Application to common structured products

This section illustrates the principles described above by demonstrating their application to a number of common structured products.

Prepaid forwards

Prepaid forwards refer to a broad group of instruments that contemplate an upfront payment by an investor in exchange for a single payment at maturity linked to the performance of a particular reference asset (the underlier), whether physically settled or cash settled. They are commonly linked to an equity index, such as the S&P 500 or Russell 2000, to an ETF, or to one or more stocks. Common variants provide for downside protection in the form of a

buffer²² or a trigger,²³ a levered return with a maximum upside, or both. As long as any buffer or trigger feature is not so large as to raise the possibility of the instrument being characterised as debt (buffers of around 30 per cent and triggers of even 40 per cent or above are commonly treated as acceptable), these instruments are treated as open transactions resulting in capital gain or loss on maturity to US investors and no interim recognition of income. For non-US investors, any amounts received on these instruments generally will not be subject to US withholding tax.

Non-principal protected instruments with contingent coupons

Contingent coupon instruments are instruments linked to an underlier that pay a periodic coupon to the investor if the underlier is above a minimum threshold on the relevant testing date for the coupon. An investor typically does not participate in any upside at maturity, but bears the downside risk beyond a buffer or trigger. To compensate for this risk, the coupons are usually far in excess of prevailing interest rates. While the instrument itself generally is regarded as an open transaction, generating capital gain or loss to US investors at maturity, the proper treatment of the coupons is a matter of substantial uncertainty. As an economic matter, portions of the coupons may be characterised in various ways, such as option premium, interest on a loan, or a return of principal. Out of an abundance of caution, the market has adopted the view that these coupons are treated as unspecified ordinary income when received. This treatment, in conjunction with the fact that any losses at maturity are treated as capital losses, may produce adverse tax consequences to US taxpaying investors. For non-US investors, any capital gains generally will not be subject to withholding tax. However, due to the uncertain nature of the coupons, withholding agents may treat any coupon as subject to withholding (unless the investor qualifies for a treaty exemption).

Fixed-coupon instruments

Instruments that provide for fixed-rate coupons and are principal protected are treated as debt, as described above under 'Debt'. Assuming that any OID is *de minimis*, the coupons are treated as interest (ordinary income), and gain or loss on disposition not attributable to interest is capital gain or loss. Non-US investors will generally be exempt from withholding on interest payments under the portfolio interest exemption.

Fixed-coupon instruments also come in non-principal-protected variations, which are linked to the performance of one or more underliers. An investor in such instruments generally bears the downside risk of the underlier or underliers (generally beyond a buffer or upon the tripping of a trigger) and may have no participation in the upside (reverse convertibles or reverse exchangeables) or may have limited participation in the upside (mandatory exchangeables). It is common practice to apply a component analysis to fixed-coupon instruments with no upside and to treat these instruments as a combination of a deposit by the investor with the issuer and a put option written by the investor to the issuer. A portion of each coupon payment is thus treated as interest on the deposit (determined by using the

22 A buffer is a minimum percentage decline in the underlier before which the investor is not subject to loss, and thereafter, loss is incurred on a 1:1 basis on amounts below the threshold such that, for example, a buffer of 30 per cent with a decline in the underlier of 31 per cent will yield a 1 per cent loss.

23 A trigger is a minimum percentage decline before which the investor is not subject to loss, and thereafter, the entirety of the loss is 'triggered' such that, for example, a trigger of 30 per cent with a decline in the underlier of 31 per cent, will yield a 31 per cent loss.

comparable interest rate the issuer would pay on similar loans) and includible in income by a US investor when accrued or received (in accordance with the US investor's method of accounting for US tax purposes), while the remaining portion is treated as premium on the put option. Under the tax rules governing options, a put premium is not taxable when received because it is unclear at that point whether the writer will ultimately have an economic gain or loss. Rather, if at maturity the underlier has not declined below any buffer or trigger and the initial investment (plus any final coupon) is returned to the investor (i.e., the put effectively expired unexercised), the total amount of premium is then taxable to a US investor as short-term capital gain. If, on the other hand, the US investor receives less than the entire initial investment, the investor recognises at maturity short-term capital gain or loss equal to the difference between the amount received at maturity (excluding any final coupon paid at maturity) plus the total put premium paid, and the initial investment amount (the deposit). The issuer generally publishes the portion of the coupon includible as interest and the portion attributable to put premium in the final disclosure accompanying the product documents.

For non-US investors, the portion of a coupon that is interest will generally qualify for the portfolio interest exemption, while any amounts that result in capital gain will generally not be subject to withholding.

When non-principal-protected fixed coupon instruments provide for some upside exposure at maturity, market practice is generally to treat the coupons as ordinary income under the same conservative approach used for contingent coupon notes described above. At maturity, if they are cash settled, a US investor recognises capital gain or loss generally equal to the difference between the initial investment and the amount received. If they are physically settled for stock, no gain or loss is recognised, and the investor takes the same tax basis in the stock as it had in the note. Upon disposition of the stock, the investor will then recognise capital gain or loss, as appropriate. As with non-principal-protected contingent coupon instruments, non-US investors may be subject to withholding on the coupons (unless a treaty exemption applies).

Equity-linked notes

Certain equity-linked notes are principal-protected instruments where the payment at maturity is linked to the performance of an index, a particular equity or a basket of equities. In one very common form, they are 100 per cent principal-protected and provide for no payment other than a payment at maturity reflecting the appreciation of the underlier (on a 1:1 or on a leveraged basis). Because they are principal-protected, they clearly are debt. However, as they do not provide for interest payments, but rather a contingent payment at maturity, they are treated as CPDIs. Accordingly, a US investor is subject to the rules governing CPDIs described above. Non-US investors generally will be exempt from withholding under the portfolio interest exemption.

v Afterword

The taxation of structured products is a nuanced field and commonly subject to some degree of uncertainty. Moreover, the relevant tax considerations may vary significantly based on an investor's particular status and circumstances. Investors for whom tax considerations are important are best advised to carefully read the tax disclosure that accompanies an investment product and to seek expert guidance on the tax consequences applicable to their particular situation.

VI OTHER ISSUES

i Issues to consider with complex products

Regulators in the United States have long had, and continue to have, a focus on product complexity. This encompasses both complex structures and complex underlying reference assets.

In the case of the SEC, on 28 October 2020, then Chairman Clayton issued a joint statement with three division directors regarding complex financial products and retail investors. The authors noted that they believed that complex products may present investor protection issues, particularly for retail investors who may not fully appreciate the particular characteristics or risks of these investments, including the risks that holding these products may pose to their investment goals.

In the case of FINRA, Notice to Members 05-26 (New Products), published by its predecessor, the National Association of Securities Dealers (NASD), began by noting that NASD was concerned about the number of increasingly complex products being introduced to the market, some of which were described as having unique features that may not be well-understood by investors and others of which were described as raising concerns about suitability and potential conflicts of interest. In describing procedures for vetting new products, NASD indicated that every firm should ask and answer, before a new product is offered for sale, whether complexity of the product in terms of structure, function or description impairs the understanding and transparency of the product and suitability considerations, or the training requirements associated with the product, or both.

In its Regulatory Notice 12-03 (Heightened Supervision of Complex Products), FINRA discussed the risks that it considered were raised by a number of different types of products, including the possibility that the product will not perform as many investors anticipate or that it might be inappropriately sold on the basis of enhanced yield, principal protection or the tracking of an index or a reference asset. According to FINRA, '[a]ny product with multiple features that affect its investment returns differently under various scenarios is potentially complex', citing as examples '[p]roducts that include an embedded derivative component that may be difficult to understand', such as 'steepener' notes and reverse convertible notes, and structured products with 'worst-of' features. FINRA says:

- a the decision to recommend complex products to retail investors is one that a firm should make only after the firm has implemented heightened supervisory and compliance procedures;
- b firms should rigorously monitor the extent to which these procedures address the various investor protection concerns raised by the recommendation of complex products to retail investors; and
- c firms should monitor the sale of these products in a manner that is reasonably designed to ensure that each product is recommended only to a customer who understands the essential features of the product and for whom the product is suitable.

In addition, FINRA highlighted in its 2021 Report on FINRA's Examination and Risk Monitoring Program that, '[a]s always', it remains focused on reviewing member firms' communications relating to complex products. In its 2019 Risk Monitoring and Examination Priorities Letter, FINRA indicated that firms should expect that FINRA will review for compliance regarding its ongoing areas of focus, specifically referencing obligations related to suitability determinations, including with respect to recommendations relating to complex products. This echoes themes raised in its December 2018 Report of FINRA Examination

Findings, in which FINRA noted that it had observed unsuitable recommendations involving complex products and identified, as an example of one of the sound supervisory practices for suitability that it had observed, a requirement that registered representatives receive training on specific complex or high-risk products before recommending them so that the representatives understood the products' risks and performance characteristics, as well as the types of investors for whom a product might be suitable.

An area of growing interest is the potential issuance of structured products linked to cryptocurrencies. In a 2015 speech, Amy M Starr, Chief, Office of Capital Market Trends encouraged market participants to speak to the SEC staff before introducing certain new or novel products.²⁴ It is likely that cryptocurrency-linked structured products would receive SEC focus and scrutiny. While there have been SEC-registered offerings of structured products linked to companies with exposure to cryptocurrency, there have not as yet been any offerings linked to any cryptocurrency.

ii The impact of the coronavirus (covid-19) pandemic

The coronavirus (covid-19) pandemic has presented unprecedented challenges to business around the globe and the structured products market has not been immune to its impacts. The economic impact of the covid-19 pandemic resulted in additional risk disclosures in structured product offering documents and the resulting market volatility also caused marketing, pricing and trading issues.

In March 2020, the SEC issued guidance, which was supplemented in June 2020, regarding disclosure that companies should consider with respect to covid-19 and related business and market disruptions. As a general matter, the guidance 'encourage[s] companies to provide disclosures that allow investors to evaluate the current and expected impact of covid-19 through the eyes of management and to proactively revise and update disclosures as facts and circumstances change'.²⁵ Additionally, the guidance makes clear that the effects that covid-19 has had on a company, including what management believes the impact might be, how the company is planning for covid-19-related uncertainties and how management is responding, could be material information for investors. In response, many structured product issuers began to include risk disclosure in their offering documents (or in the Exchange Act filings that are incorporated by reference into the offering documents) addressing the pandemic's effect as it relates to the operations, liquidity and capital resources of the issuer. In addition, some structured product issuers have added risk disclosures to their offering documents regarding the covid-19 pandemic's impact on the underlying reference asset and the stock market in general. This type of disclosure, unlike the disclosure regarding the covid-19 pandemic's impact on the issuer's business operations, has not been universally adopted.

The volatility index of Chicago Board Options Exchange, known as the VIX index, reached a peak of 82.7 on 16 March 2020, which was higher than during the 2008 financial crisis and significantly higher than its long-run volatility average of approximately 20.

24 Amy S Starr, 'Structured Products – Complexity and Disclosure – Do Retail Investors Really Understand What They Are Buying and What the Risks Are?': <https://www.sec.gov/news/speech/speech-amy-starr-structured-products-.html> (accessed 26 July 2021).

25 See US Securities and Exchange Commission, 'Coronavirus (COVID-19) — Disclosure Considerations Regarding Operations, Liquidity, and Capital Resources' CF Disclosure Guidance: Topic No. 9A (dated 23 June 2020): <https://www.sec.gov/corpfin/covid-19-disclosure-considerations>.

The market volatility caused by the covid-19 pandemic caused structured product issuers to reassess the appropriate way to offer these securities, and required significant issuer and distributor efforts to appropriately price and sell structured products. For example, structured products in the United States have traditionally been offered on a monthly calendar cycle where products are launched at the beginning of the month and priced at the end of the month. During the periods of increased market volatility, it can be difficult for issuers to hold static the same pricing terms of an issuance for the entire monthly marketing period. Large market swings would typically mean that the pricing offered at the beginning of the month would be out of sync with market levels at the end of the month. As a result, many issuers moved to a weekly calendar or even shorter marketing periods in the second quarter of 2020. While volatility has declined in the US significantly from its peak in March 2020, volatility has not stabilised to pre-pandemic levels and continues to experience spikes. For example, the VIX index, posted its biggest jump in two years on 27 January 2021 when it saw an increase of 62 per cent, from below 25 to above 37. Again, on 19 July 2021, the VIX index spiked 22 per cent. While the covid-19 pandemic is much more under control in large part due to the success of the vaccines, concerns about new variants, such as the delta variant, look to be seeping into the volatility markets. These changes to the marketing calendar and increased effort to appropriately price these products have largely remained thus far, and time will tell whether the industry reverts to its earlier timetables or makes further changes to the way it markets these products.

The volatility caused by the covid-19 pandemic also had a significant impact on structured products that provide exposure to oil markets. The declined demand for oil due to the lockdowns related to covid-19, together with rising global oil supply and diminished storage capacity, resulted in record low crude oil prices. The WTI crude oil futures contracts for May 2020 delivery fell into negative territory for the first time ever, settling at negative US\$37.63 per barrel shortly before expiration – meaning sellers were willing to pay buyers to take barrels off their hands. The next day, the WTI crude oil futures contracts for June 2020 delivery fell 43 per cent to close at US\$11.57 per barrel. Due to these extraordinary events in the crude oil market, structured products that provide exposure to oil experienced significant volatility, problems with valuation and issues with commodity index calculations. For example, with respect to ETNs, this volatility caused dislocation between the trading price of the ETNs and their indicative value – often resulting in the ETN trading at a premium above its indicative value. In addition, some issuers had to redeem the ETNs affected by negative underlying values or find alternative ways to hedge such ETNs. Such redemption or hedging adjustment required careful planning by the issuers ahead of time in order to avoid any legal or regulatory issues down the road.

In response to the decline in oil demand and oil prices, FINRA released a notice on 15 May 2020 to its members regarding exchange-traded products (ETPs) (which includes ETNs) that provide exposure to oil markets. The FINRA notice warned that some investors may not understand oil-linked ETPs' investment objectives, including the difference between the futures price and the spot price and the impact of rolling. The FINRA notice 'reminds firms of their sales practice obligations in connection with oil-linked ETPs, including that recommendations to customers must be based on a full understanding of the terms, features, and risks of the product recommended; communications with the public must be fair and

accurate; firms must have reasonably designed supervisory procedures in place to ensure that these obligations are met; and firms that offer oil-linked ETPs must train registered representatives who sell these products about the terms, features and risks of these products'.²⁶

iii Environmental, social and governance products

Another area of growing interest is environmental, social and governance (ESG) products. In some cases, these have taken the form of 'social' or 'green' bonds, where the proceeds are allocated to new or existing projects, or both, with social or environmental benefits (often linked to the United Nations' Sustainable Development Goals). While such instruments are often issued with a 'plain vanilla' structure, there have been SEC-registered offerings of green bonds with a structured payout. 'Social' or 'green' bonds involve the careful preparation of use of proceeds disclosure that accurately describes how the proceeds will be allocated. In addition, investors have focused on what ongoing reporting, if any, will be provided about the allocation of funds after the instrument has been issued. There is also significant market focus on 'greenwashing', which includes making misleading claims about environmental credentials or products, such as overstating the environmental benefits of a project to which funds are allocated. Allegations of greenwashing present a significant reputation risk for market participants involved in offerings of ESG products. The SEC has also begun to focus on ESG-related disclosures.

There have also been offerings of structured products linked to ESG-related underlying assets, such as ESG funds and indices that have the goal of tracking the performance of companies that exhibit a commitment to certain ESG-related goals. As with any index-linked structured product, a key focus for products linked to ESG indices is the preparation of an accurate description of the index, as well as related risk factors, for inclusion in the offering documents. As these indices can involve some amount of discretion in the selection of their components, the risk factors often highlight the fact that the component selection in accordance with the index's methodology may differ significantly from alternative approaches and investor expectations.

iv Recent developments in benchmark reform

The impact of the LIBOR transition

The transition from LIBOR to alternative reference rates will have a significant impact on the US structured product market as many structured products reference LIBOR. In addition to structured products that pay an interest rate based on LIBOR, LIBOR has also effectively been used as an underlying reference asset for structured products (e.g., the payment at maturity depends on the percentage change in LIBOR over the term). Furthermore, many proprietary indices that are used as underlying reference assets for structured products have returns based on LIBOR or contain embedded costs or fees calculated by reference to LIBOR.

For legacy structured products, the contractual fallback language was typically intended to address a temporary unavailability of LIBOR, not its permanent discontinuation. For example, for interest-bearing products, the fallback language typically provides that if LIBOR is not available, the rate will be determined by reference to quotations by reference banks and, if the reference banks are not quoting, LIBOR for the relevant interest determination date will remain LIBOR for the immediately preceding interest reset period. Without a

26 See FINRA Regulatory Notice 20-14.

change to the terms (whether effected via holder consent or legislation), the effect of this fallback language is that such products, which were intended to be floating rate instruments, would become fixed rate instruments, with the interest rate being fixed at LIBOR prior to its discontinuation, and no longer fluctuating based on changes in interest rates. As a result, in many cases, fallback language in legacy products might produce unintended economic outcomes of turning an instrument that uses a floating rate to one that is effectively tied to a fixed rate. Unlike many English law-governed products, New York law-governed products typically require the consent of each holder to amend the interest rate. However, in April 2021, New York's LIBOR legislation was signed into law. At a high level, the legislation applies to certain contracts, securities and instruments that (i) are governed by New York law and (ii) have interest or dividend rates based on US dollar LIBOR. The legislation effectively buckets contracts into three categories:

- a* contracts with no fallbacks or fallbacks based on LIBOR. For these contracts, LIBOR will be replaced by operation of law with the 'recommended benchmark replacement' (i.e., a benchmark replacement based on the Secured Overnight Financing Rate (SOFR), including any spread adjustment and conforming changes), with the benefit of a safe harbour;
- b* contracts with fallbacks not based on LIBOR (e.g., the prime rate or the federal funds rate), which are not changed by the legislation; and
- c* contracts with fallbacks that permit or require the selection of a benchmark replacement that is based on LIBOR or a replacement for/equivalent to LIBOR. For these contracts, the determining person will have the authority, but not be required, to select the recommended benchmark replacement, with the benefit of a safe harbour if such authority is exercised.

The safe harbour creates a shield against liability for the selection or use of a recommended benchmark replacement and provides that such selection or use will not have the effect of discharging or excusing performance under any contract, give any person the right to unilaterally terminate or suspend performance or constitute a breach. In addition to New York, Alabama has adopted similar legislation and work is also underway on federal legislation.

US regulators urged market participants to stop issuing new products using LIBOR by the end of 2021. For new structured products, issuers can select an alternative interest rate to LIBOR at issuance. If the issuer wishes to continue to reference LIBOR at issuance, it can use fallback language that expressly contemplates and addresses the consequences of the discontinuation of LIBOR and related events. The Alternative Reference Rates Committee, a group of private market participants and regulators convened by the Federal Reserve Board and the Federal Reserve Bank of New York (ARRC), has published recommended fallback language for market participants to consider for new issuances of various types of cash products referencing LIBOR, including floating rate notes. The goal of this language is to reduce the risk of serious market disruption following a LIBOR cessation by providing for LIBOR to be replaced with a different rate (such as SOFR) following a trigger that precipitates the transition away from LIBOR. Published on 25 April 2019, this language has been used by issuers of structured products that pay an interest rate based on LIBOR, as well as those that use LIBOR as an underlying reference asset.

Constant maturity swap-linked structured products

Because most ICE Swap Rates (ISRs) are calculated by reference to LIBOR, the market has been focusing on the impact of the LIBOR transition on contracts that reference these ISRs. In addition, there have been issues with the availability of these rates. From August 2019 to May 2020, certain US dollar LIBOR ISRs were not published on a significant number of scheduled publication days. ICE Benchmark Administration Limited (IBA) has indicated that it expects to consult on the potential cessation of the US dollar LIBOR ISRs in due course. IBA has not launched any SOFR ISRs, but has indicated that it will consider doing so if and when eligible input data are available. In light of these developments, many issuers have moved to add provisions, including fallback language, that expressly contemplates the temporary unavailability, as well as the permanent discontinuation, of the applicable US dollar LIBOR ISRs and the replacement of such rates with alternatives.

Structured products linked to SOFR and other alternative rates to LIBOR

SOFR has been identified by the ARRC as its recommended alternative to US dollar LIBOR for certain financial contracts. SOFR is intended to be a broad measure of the cost of borrowing cash overnight collateralised by US Treasury securities. The volume of new issuances of securities, including structured products, linked to SOFR in the US market continues to grow. In addition, there has been an increase in the volume of new issuances linked to other alternative rates to LIBOR, including AMERIBOR, which is based on certain overnight unsecured loan transactions, and the Bloomberg Short Term Bank Yield Index (BSBY), which is based on certain bank funding transactions. The SEC has cautioned the market that these alternative rates may have the same flaws as LIBOR as they also may not be based upon a sufficiently robust market of underlying transactions. Accordingly, the open question in the US market is whether it will embrace a range of LIBOR replacements or consolidate around SOFR.

VII OUTLOOK AND CONCLUSIONS

The legal and regulatory environment in the United States as it relates to structured products is dynamic and continues to evolve. Regulation Best Interest, which went into effect in June 2020, is only the most recent in a series of significant regulatory developments that have impacted the ways in which structured products are offered and sold in recent years. At the same time, the structured products marketplace continues to grow and change. Manufacturers of structured products continually seek to innovate and design new products to help their customers meet their investment objectives. Developments such as open architecture and new technology platforms continue to change the ways in which structured products are distributed.

Despite this continual change, the central focus of regulators in the United States has remained constant: ensuring that structured products are sold only to investors who fully understand their features and risks and for whom they are appropriate. Disclosure is the cornerstone of the regulatory regime for securities in the United States, and ensuring that disclosures are full and fair and provide investors with an adequate basis on which to make an informed investment decision has long been a key focus of the SEC in the structured products area. The staff of the SEC regularly reviews disclosure documents filed by issuers with the SEC and has from time to time identified ways to improve disclosures. Many of the now-standard features of structured product disclosure in the United States, including

disclosure of the estimated value of securities, product titles and certain ETN disclosures, can be traced to SEC disclosure reviews. SEC guidance is likely to continue to shape disclosure practices in the future. That is particularly likely to be the case with respect to new products, as the SEC staff actively encourages issuers to consult with it on disclosure issues that arise in connection with developing new products.

Although good disclosure is necessary, it is not by itself sufficient, and both the SEC and FINRA remain focused on ensuring that broker-dealers meet their sales practice obligations in connection with sales of structured products. Those obligations include understanding the terms of the securities the broker-dealer is recommending (good disclosure is essential in this regard) and ensuring that recommendations are in the best interest of their customers. We expect these areas to remain a continued focus of regulators in the United States in the years to come.

ABOUT THE AUTHORS

CHRISTOPHER S SCHELL

Davis Polk & Wardwell LLP

Christopher S Schell is a partner in Davis Polk's corporate department, practising in the derivatives and structured products group. He regularly advises financial institutions on numerous types of domestic and international debt and equity capital markets transactions. He represents issuers and investment banks. His practice focuses on advising financial institutions in connection with their capital markets offerings and issues related to those offerings such as the Federal Reserve's TLAC rules or the current LIBOR transition. Within this capital markets practice, he has over a decade of expertise in structured product transactions, including synthetic exchangeable securities and other equity, commodity and currency linked products. He has extensive experience developing new financial products, including innovative offerings of units, warrants, exchange traded notes and proprietary indexes, for both retail and institutional investors.

YAN ZHANG

Davis Polk & Wardwell LLP

Yan Zhang is a partner in Davis Polk's corporate department, practising in the derivatives and structured products group. She regularly represents financial institutions on securities offerings of structured products linked to equities, commodities, currencies, rates and combinations of these assets. Ms Zhang has extensive experience in the development of new financial products, including exchange traded notes and proprietary indices for retail and institutional investors. She also advises financial institutions, corporations and investment funds in structuring, negotiating and documenting equity derivatives transactions as well as offerings of convertible and exchangeable securities.

DEREK WALTERS

Davis Polk & Wardwell LLP

Derek Walters is a partner in Davis Polk's corporate department, practising in the derivatives and structured products group. He advises financial institutions, companies and investors on equity derivatives and other structured transactions, including convertible notes, margin loans secured by significant positions in public companies, over-the-counter derivatives and structured products. His practice encompasses transaction execution as well as product development and regulatory compliance.

DAVIS POLK & WARDWELL LLP

450 Lexington Avenue

New York, NY 10017

United States

Tel: +1 212 450 4011 / 4463 / 4235 / 4000

Fax: +1 212 450 5759 / 4990 / 6852

christopher.schell@davispolk.com

yan.zhang@davispolk.com

derek.walters@davispolk.com

www.davispolk.com

an LBR business

ISBN 978-1-83862-831-4