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Structured Thoughts

News for the financial services community.

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Nasdaq Proposes Listing Rules Relating to Structured Products

In January 2012, Nasdaq proposed new rules for the listing and trading of a wide variety of structured notes and other related products.[1] These rules would apply to equity-linked, commodity-linked, and other notes.

The proposed rules are based on the listing standards of NYSE Arca, where most U.S.-listed structured products currently trade. In the proposal, Nasdaq indicates that one of the purposes of the proposal is to promote competition and deeper markets.

Amended Nasdaq Rule 5710 would provide the continued listing standards for equity-linked and commodity-linked securities, together with initial and continuing listing standards for fixed-income linked, futures-linked, and multifactor index-linked securities. New Nasdaq Rule 5711 would include listing standards for:

- index-linked exchangeable notes;
- equity gold shares;
- trust certificates;

[1] Nasdaq's proposal can be found at the following link: http://nasdaq.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2012/SR-NASDAQ-2012-013.pdf.

- commodity-based trust shares;
- currency trust shares;
- commodity index trust shares;
- commodity futures trust shares;
- partnership units;
- trust units;
- managed trust securities; and
- currency warrants.

The proposals also include provisions for delisting these types of securities, and requirements for market makers in these securities.

Nasdaq has requested that the SEC approve the proposed listing rules on an accelerated basis.

A listing of a particular structured product may not ensure that its holders will enjoy significant liquidity. But the proposal does potentially provide issuers with an additional option in listing structured products, potentially improving the competitiveness of the market for these listings.

Texas District Court Issues Ruling on Application of the 1933 Act on CDs

In November 2011, the United States District Court for the Northern District of Texas held that certain certificates of deposit, or CDs, sold by R. Allen Stanford ("Stanford") through Stanford International Bank, Ltd. ("SIB"), should be treated as securities under the federal securities laws.[2]

The case provides some insight and reminders as to the question of when CDs are subject to the registration requirements of the federal securities laws. Section 2(a)(1) of the Securities Act of 1933 includes "certificates of deposit" in the definition of the term "security." However, relevant federal judicial and regulatory guidance has held that FDIC-insured CDs are generally not considered practitioners "securities" under the U.S. federal securities laws[3] and this has been a common understanding shared among securities lawyers and insiders. The Texas court's decision serves as a reminder that the courts are willing to carefully scrutinize CDs offered to investors, and provides issuers with judicial guidance as to the approach courts are willing to take in order to make such an assessment.

The Allegations

On February 17, 2009, the Securities and Exchange Commission (the "SEC") filed a civil enforcement action against Stanford, SIB, Stanford Group Company ("SGC"), Stanford Capital Management, LLC, and several related persons. The SEC alleged that Stanford and Davis, "through entities under his control, executed a massive Ponzi scheme…and misappropriated billions of dollars of investor funds and falsified SIB's financial statements in an effort to conceal their fraudulent conduct." The complaint further alleges that, between 2005 and 2008, Stanford, through SIB, sold to investors self-styled "CDs" worth more than $7.2 billion. The CDs were primarily marketed to investors in the United States in a Regulation D private placement. In connection with the sale, SIB represented to investors, through marketing brochures, reports, financial statements, public presentations, etc., that:

[2] *SEC v. Stanford International Bank Ltd.* (N.D. Tex. 2011).
[3] For a further discussion of the structured certificates of deposit, see Volume 1, Issue 13 of *Structured Thoughts* at http://www.mofo.com/files/Uploads/Images/101004-Structured-Thoughts-Issue-13.pdf.

1. their assets were invested in a "globally diversified portfolio of marketable securities";

2. the bank had averaged double-digit returns on its investments over a period of 15 years;

3. Stanford had strengthened SIB's capital position by investing $541 million in capital into the bank;

4. the bank's portfolio was managed by a global network of portfolio managers and monitored by a team of SFG analysts;

5. the bank had a strong capital position; and

6. the bank did not have exposure to losses from investments as a result of the Madoff fraud scheme.

Analysis

The court held that the CDs sold by SIB were "securities" under Section 2(a) of the Securities Act. The court began its analysis by citing the Supreme Court's holding in *Marine Bank v. Weaver*.[4] In *Marine Bank*, the Court held that FDIC-insured CDs were not securities because they were subject to a comprehensive set of regulations that provided abundant protection under federal banking law. However, the Court added that each "transaction should be evaluated on the basis of the content of the instrument in question, the intended purpose to be served and the factual setting as a whole."[5]

In order to evaluate the CDs, the Court in *Marine Bank* employed the "family resemblance tests" articulated by the Supreme Court in *Reeves v. Ernst & Young*.[6] The family resemblance test begins with the rebuttable presumption that all notes are securities.[7] This presumption is overcome if the security bears a strong resemblance to one of a judicially crafted list of categories of instrument that are not securities.[8] To determine whether a security bears a resemblance to one of the exceptions, the Court set forth the following four factors:

i. the motivation of the parties to enter into the transaction;

ii. the means by which the purchaser will acquire the instrument;

iii. the reasonable expectation of the investing parties; and

iv. the existence of factors which would reduce the risk of the instrument.[9]

v. the burden of proof under the family resemblance tests shifts to the party contending that the note is not a security. The Texas court's application of the family resemblance factors are outlined below.

1. The motivation of the parties to enter into the transaction.

Under the first factor of the family resemblance test, an instrument is likely to be a security if the "seller's purpose is to raise money for general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit that the instrument is expected to generate." As applied to the Stanford case, the SEC argued that Stanford solicited investors to buy the CDs by claiming high returns due to SBIC's reinvestment in a "globally diversified portfolio." Further, Stanford's purpose in selling the CDs was to reinvest the money into a

[4] 455 U.S. 551 (1982).
[5] *Id*. at 558, 560 n. 11.
[6] 494 U.S. 56 (1990).
[7] *Id*. at 65.
[8] *Id*.
[9] *Id*. at 66-67.

"globally diversified portfolio." As such, the Texas court held that the first prong was satisfied because that the investors' motivation for purchasing the CDs was to benefit from the abnormally high returns.[10]

2. The means by which the purchaser will acquire the instrument.

The next factor examines the means by which purchasers acquired the instrument to determine whether there is common trading for speculation or investment. In its analysis, the Court has noted that an offering and sale to a broad segment of the public is all that is necessary to demonstrate a "common trading." For instance, in *Reeves*, a cooperative sold promissory notes to over 1,600 people by offering them to its 23,000 members, as well as to nonmembers, leading the court to conclude that the notes were "offered and sold to a broad segment of the public, and that is all we have held to be necessary to establish the requisite 'common trading' in an instrument" characteristic of a security.[11]

Between 2005 and 2008, SIB sold more than $7.2 billion worth of CDs and marketed them to investors in the United States through the use of marketing brochures. The Texas court agreed that the actions taken by SIB in connection with the sale of CDs evidenced a "common trading."[12]

3. The reasonable expectation of the investing parties.

Under the third factor of the family resemblance test, the courts must consider instruments to be securities based on the reasonable expectation of the public, even where an economic analysis of the circumstances of a transaction might suggest otherwise. Here, the court focused on SIB's filing of Form D, "Notice of Sale of Securities" with the SEC, effectively ensuring[13] investors that the offer and sale of the CDs were subject to the anti-fraud provisions of federal securities law, and held that it was reasonable for the investing public to believe that the CDs were securities.

In contract, the structured CD market, issuers and underwriters typically take careful steps to help ensure that investors will understand and appreciate that these products are certificates of deposit, and not securities. This is typically achieved through a significant amount of disclosure in the relevant offering documents, together with a broker's own explanations. A variety of issuers also use additional brochures or marketing materials to address this point.

4. The existence of factors that would reduce the risk of the instrument.

The final factor examines whether there are any factors that would reduce the risk of the instrument, and therefore render the protections of the securities laws unnecessary.[14] Generally, where an instrument is subject to a separate regulatory scheme, courts have found that the instrument does not need to be protected by the securities laws.[15] As applied to this case, the court held that there was no indication that Stanford took efforts to reduce the risk of the CDs. The CDs offered to investors were highly speculative debt instruments, with no backing in a "globally

[10] In the case of many retail structured CDs, this part of the analysis would appear to cut both ways. On the one hand, the proceeds from a CD offering are generally used for the issuer's general corporate purposes. On the other hand, structured CDs are usually advertised as only potentially outperforming other types of instruments, and the relevant offering documents are usually fairly conservative about estimating the investor's potential for returns; for example, some CDs are subject to "return caps" or low "participation rates," and there may be potential adverse movements in the value of the relevant underlying assets that would reduce (and potentially eliminate) any positive return that an investor may receive.
[11] *Id*. at 62.
[12] This part of the analysis would appear to cut both ways with regard to structured CDs. On the one hand, many of these instruments are marketed broadly using disclosure statements, brochures and other materials. On the other hand, other bank products which are not generally considered "securities" are also marketed broadly, such as "plain vanilla" fixed-interest CDs.
[13] Or perhaps, *admitting* that these instruments were securities.
[14] For example, in *Marine Bank*, the holders of FDIC-insured certificates of deposits were guaranteed payment of principal by the U.S. government. Therefore, the Court held that it was not necessary to provide to CD holders the added protections which are afforded under the federal securities laws.
[15] The availability of separate regulatory schemes was a key basis for the Court's holding in *Marine Bank.*

diversified portfolio." Stanford allegedly used the capital generated from the sale of the CDs as "loans," the majority of which were never repaid. In sum, there was no indication that the CDs offered were equivalent to typical types of U.S. regulated bank CDs.

This prong of the test typically works to support the analysis that FDIC-insured CDs, including structured CDs, are not securities. Subject to applicable deposit limitations, the principal amount of these instruments is guaranteed by the "full faith and credit" of the U.S. government.

Conclusion

The Texas court's decision serves as additional guidance to issuers engaged in the sale of CDs. Typically, courts are willing to exempt FDIC-insured CDs from the definition of "securities" under Section 2(a)(1). In all other cases, the courts will heavily scrutinize CDs offered to investors. Accordingly, issuers, brokers and their counsel should view the Texas court's application of the "family resemblance" as both a reminder of the extent to which courts will go to analyze CDs, and as judicial guidance as to the type of analysis courts are willing to adopt in order to make such a determination.

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