Morrison & Foerster News Bulletin Volume 6, Issue 3 May 1, 2015

Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

The National Senior Investor Initiative……..Page 1

SEC Commissioner Addresses Structured Notes..……………...……...Page 3

The SEC Defines "Voting Equity Securities" Under the Rule 506(d) Bad Actor Disqualification Rules…………………....Page 4

For Members Only: FINRA Updates Rules re: Payments to Non-Members............Page 5

Losing WKSI Status: Consequences for Structured Note Dealers..……………...Page 6

The National Senior Investor Initiative

On April 15, 2015, the SEC's Office of Internal Compliance Inspections and Examinations (OCIE), together with FINRA, released a report focusing on sales of investment products to seniors, including investments in structured products.[1] The report, as well as increased scrutiny by the SEC and FINRA on investments by the elderly in general, is a reflection of the aging American population and the need of many of them for higher-yielding investments. Further, traditional investments, such as savings accounts, are earning historically low yields, resulting in an increased interest in non-traditional securities.

The report is based on 44 examinations conducted in 2013, which focused on how firms conduct business with senior investors.

Structure of the Report

The report addresses a number of key areas in which FINRA and other regulations impact sales to senior investors. Each section summarizes the relevant rules, referring in many cases to prior FINRA statements. Most of these sections are followed by "Notable Practices," which appear to represent recommendations from FINRA and the OCIE. These sections include:

- Training
- Use of Senior Designations

[1] FINRA News Release: SEC Staff and FINRA Issue Report on National Senior Investor Initiative (April 15, 2015), *available at* https://www.finra.org/newsroom/2015/sec-staff-and-finra-issue-report-national-senior-investor-initiative.

Attorney Advertising

- Marketing and Communications
- Account Documentation
- Suitability
- Disclosures
- Customer Complaints
- Supervision

Of course, although they may be useful for many firms, the report concludes that these “Notable Practices” are not intended to be a “safe harbor” or a checklist for good compliance; each member firm must consider the relevant issues in light of its business.

Focus on Structured Products

Significant Sales. Consistent with prior practice, the report pays significant attention to this asset class. Structured products accounted for one of the top five categories of sales at 11% of the firms surveyed.[2]

Suitability Issues. The report notes that 7% of the firms made potentially unsuitable recommendations for sales of structured notes and market-linked CDs. In particular, “[i]t appeared that firm representatives failed to consider investors’ risk tolerances, investment concentrations, the illiquid nature of these securities, and investors’ age and time horizon when assessing suitability. For example, representatives made multiple recommendations for market-linked CDs, which exceeded maximum firm thresholds of investable assets and product concentrations.”[3]

On the other hand, the report points out that the industry’s policies and procedures relating to the sales of structured products are paying increased attention to the issues relating to sales to senior investors. For example, FINRA noted policies that involved the pre-approval of purchases by customers aged 70 or older or prohibitions on sales of structured products to customers above a specific age unless the firm granted an exception.

Recommendations and Conclusions

In the report, the OCIE and FINRA examine steps a firm may take to better protect elderly investors from the risks related to these investments. These steps include providing training for employees to ensure that representatives understand the needs of their senior investors, as well as establishing guidelines for determining the suitability of an investment for an individual customer. These guidelines may include a customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the representative in connection with the recommendation. Specifically, when dealing with structured products or other non-traditional securities, OCIE and FINRA suggest that representatives focus on the appropriateness of exchanges, excessive fees, concentration of liquid net worth, short investment time horizon, and age to determine suitability.

Because of the current investment environment, the issues addressed in this report will likely remain a priority for the SEC and FINRA. Additionally, regulators at the state level are also focused on the risks related to structured products and are looking to partner with the SEC and FINRA to help regulate the sell of these products.[4]

---

[2] Seven other types of securities constituted a higher percentage of revenues for the surveyed firms.

[3] Notwithstanding FINRA’s regulatory actions against certain broker-dealers during the past several years, the report points out that “[o]ne such recommendation was made to an 87 year-old investor with a moderate risk tolerance, an investment objective of growth, and investment experience that was limited to mutual funds. The product would not become liquid until the investor was 94 years old, and the investment tied up a significant percentage of the investor’s assets.”

[4] Commissioner Luis A. Aguilar, “Regulators Working Together to Serve Investors” (April 14, 2014), *available at* http://www.sec.gov/news/speech/regulators-working-together-to-serve-investors.html.

SEC Commissioner Addresses Structured Notes

On April 14, 2015, in the opening speech before the North American Securities Administrators Association (the "NASAA")[5] at its Annual NASAA/SEC 19(d) Conference, SEC Commissioner Luis A. Aguilar addressed a variety of topics, including structured notes.[6]

Issues Relating to Structured Products

In his speech, Commissioner Aguilar expressed his belief that the SEC and state regulators should focus on combatting fraud involving complex products, including structured products sold to retail investors.

Commissioner Aguilar focused on a number of themes that have been addressed by the SEC, FINRA and the mainstream business press during the last several years:

- the rapid growth of the structured note market;
- the significant portion of structured notes sold to "retail investors," including elderly investors, who may not have the ability to fully understand the products that they are buying; and
- product-specific risks, including "…complex payoff structures, market risk on the reference asset or index, high fees, a lack of a liquid secondary market, opaque pricing, credit risk, and complicated payoff structures that can make it difficult to assess value, risk, and potential for growth."

In detailed footnotes, the speech cites a variety of prior regulatory actions by the SEC, FINRA, and other regulators that many readers of this publication have previously studied for guidance.

Future Actions by the SEC and Other Regulators

While not proposing any specific measures, Commissioner Aguilar stated his belief that these products warrant additional regulatory attention. He suggested that:

- the SEC staff needs to expand its focus on structured note disclosures to include all complex securities sold to retail investors; and
- the SEC staff would benefit by formally adding both NASAA and FINRA as full partners in this effort. He noted that NASAA members and FINRA have extensive experience with complex products and can provide valuable insights into how these securities are being marketed to retail investors and how to ensure that investors are protected.

Some Additional Perspective

Retail vs. High Net Worth. Commissioner Aguilar cited statistics from various sources regarding "retail" sales. However, a number of these sources make little effort to provide detailed statistics that would distinguish between actual retail investors, on the one hand, and high net worth investors, on the other hand. For example, a significant majority of the structured notes sold in the United States are sold through private banking channels to high net worth investors with financial advisers, or through advisory channels. The speech and the cited references do not distinguish among

[5] The NASAA is an association of state, provincial, and territorial securities administrators in the United States, Canada, and Mexico.
[6] The speech may be found on the SEC website at the following link: http://www.sec.gov/news/speech/regulators-working-together-to-serve-investors.html.

distribution channels and could leave a reader with significant misperceptions regarding the market for these products and who the actual purchasers are.

Older Investors. The speech also suggests that structured products are marketed and sold in disproportionate amounts to seniors. Interestingly, in a joint report, The National Senior Investor Initiative, published on April 15, 2015, by the SEC's Office of Compliance Inspections and Examinations and FINRA,[7] the agencies found that there were at least seven other types of securities more commonly sold to seniors, including, for example, variable annuities, UITs, ETFs, non-traded REITs, and BDCs. There is no allowance made for the fact that seniors may represent a disproportionate percentage of the high net worth and private banking customer universe; to a significant extent, these investors may be most interested in yield enhancement as an investment objective rather than equity appreciation.

Investor Understandng. The speech references concerns regarding investor education and the level of financial literacy. However, no mention is made regarding the efforts undertaken by the industry to promote investor education, whether through the use of free writing prospectuses that provide product information and descriptions, or through websites and other freely-available information materials. The speech also does not reference the significant efforts that broker dealers have applied to training their registered representatives in recent years, which has occurred both as a response to regulatory guidance and an effort to help ensure that investors are understanding the products that they are purchasing.

Conclusion

Commissioner Aguilar also referenced recent efforts of different groups at the SEC, including the SEC's "sweep letter" relating to "estimated values" and the efforts of the SEC's Division of Enforcement and Office of Compliance Inspections and Examinations to review structured products. While not indicating any specific actions that will be taken, Commissioner Aguilar's speech suggests that regulatory activity affecting the industry is not necessarily likely to end soon.

The SEC Defines "Voting Equity Securities" Under the Rule 506(d) Bad Actor Disqualification Rules

The SEC is continuing to tie up some loose ends left over from the adoption of the Rule 506(d) bad actor disqualification rules. Obtaining certainty regarding these open items will be beneficial for issuers and placement agents of structured products to be issued under Rule 506 under the Securities Act.

A beneficial owner of 20 percent or more of an issuer's voting equity securities is a covered person under Rule 506(d)(1) and could potentially be a bad actor subject to the rule's disqualification provisions. In the adopting release for these rules, the SEC declined to adopt a bright-line definition of the term "voting equity securities."[8] Rather, the SEC stated that the term turned on "whether securityholders have or share the ability, either currently or on a contingent basis, to control or significantly influence the management and policies of the issuer through the exercise of a voting right."[9]

Acknowledging that their initial interpretation may have been overbroad and that a "bright-line" test would be more workable, the SEC, in the recent Amendments to Regulation A Adopting Release, created a bright-line standard that is consistent with the definition of "voting securities" in Rule 405 of the Securities Act.[10] "Voting equity securities," for purposes of Rules 506(d)(1), 505 and 262(a) of the Securities Act, include only those voting equity securities which, by their terms, currently entitle the holders to vote for the election of directors. The right to vote must be presently exercisable. To clarify any confusion over the extinct "control or significantly influence" standard, the SEC stated that

---

[7] The report may be found at the following link: http://www.finra.org/sites/default/files/SEC%20National%20Senior%20Investor%20Initiative.pdf.
[8] See Release 33-9414 (July 10, 2013) at n.62 and accompanying text.
[9] *Id.*
[10] See Release 33-9741 (March 25, 2015) at n.763 and accompanying text.

"'voting equity securities' should be interpreted based on the present right to vote for the election of directors, irrespective of the existence of control or significant influence."[11]

In another resolution of an outstanding item from the Rule 506 bad actor adopting release, on March 13, 2015, the SEC issued a policy statement in which it articulated standards for granting waivers from disqualification under Rules 262(a), 505 and 506 upon a showing of good cause that it is not necessary under the circumstances that the exemption be denied.[12] The SEC stated previously that it would consider articulating standards for waivers in the future.[13]

For Members Only: FINRA Updates Rules re: Payments to Non-Members

In March 2015, FINRA issued Regulatory Notice 15-07,[14] which describes FINRA's upcoming rule changes relating to payments by FINRA member firms to non-members. The rule changes will be effective on August 24, 2015. These provisions may be of particular interest to broker-dealers that offer structured products; during the last several years, U.S. structured products distributors have engaged a variety of non-member U.S. and foreign firms to assist in promoting broader sales of these products, typically in exchange for transaction-based compensation.

FINRA Rule 2040(a) and Unregistered Persons

Rule 2040 governs transaction-based payments by FINRA members to unregistered persons. As amended, Rule 2040 will effectively "incorporate by reference" the provisions of Section 15(a) of the 1934 Act and the related guidance under that statute to determine whether an entity can receive transaction-related compensation. Rule 2040(a) will prohibit FINRA members from paying transaction-based payments to any person that is not a registered broker dealer under Section 15(a), but, due to the receipt of the payment and its related activities, is in fact required to be so registered.

How will a FINRA member determine whether a proposed recipient of a payment is required to register under Section 15(a)? For this purpose, FINRA adopted supplemental materials, which enumerate several non-exclusive ways in which a FINRA member can make this determination about another party:

- reasonably relying on previously published releases, no-action letters, or interpretations from the SEC staff that apply to their facts and circumstances;
- seeking a no-action letter from the SEC staff; or
- obtaining a legal opinion from independent, reputable U.S.-licensed counsel knowledgeable in the area.

Of course, in many cases, the determination of whether a party must register under Section 15(a) is fact-specific and requires careful assessment of the party's activities.[15] Accordingly, FINRA members will want to perform significant due diligence in connection with relying on the first bullet above. As to the second bullet above, obtaining a no-action letter from the SEC is likely to be time-consuming and possibly somewhat expensive. The third option above is likely to be most useful where the relevant third party is represented by qualified U.S. counsel that understands its business and is capable of providing this type of legal opinion on a relatively short timeframe.

Needless to say, the nature of an entity's business may vary over time. As a result, in its supplemental material, FINRA encourages members to review their determination periodically if the relevant payments are ongoing in nature. FINRA expects members to maintain books and records that reflect the determinations that are made.

[11] *Id.* at page 204.
[12] The policy statement can be found at: http://www.sec.gov/divisions/corpfin/guidance/disqualification-waivers.shtml.
[13] See Release No. 33-9414 at page 71.
[14] The notice may be found at the following link: http://www.finra.org/sites/default/files/Notice_Regulatory_15-07.pdf.
[15] The SEC's traditional thinking on the subject can be found on the sec.gov website, at the following link: http://www.sec.gov/divisions/marketreg/bdguide.htm.

Rule 2040(c) and Non-registered Foreign Finders

New Rule 2040(c) is designed to spell out the circumstances under which a FINRA member can pay transaction-related compensation to a non-registered foreign finder. This question can arise in the structured products area when a non-U.S. broker, fund manager, or other entity offers a U.S. broker to refer a client, typically in exchange for a percentage of the offering proceeds. Rule 2040(c) sets forth a relatively detailed set of requirements for these types of payments to be made, including:

1) the FINRA member must assure itself that the finder is not required to register in the United States as a broker-dealer (or is subject to a disqualification as defined in Article III, Section 4 of FINRA's By-Laws[16]), and must assure itself that the compensation arrangement does not violate applicable foreign law;

2) the finder must be a non-U.S. national or a non-U.S. entity that is domiciled outside of the United States;

3) the customers to whom the securities are sold must be non-U.S. nationals or non-U.S. entities domiciled outside of the United States;

4) the customers must receive a descriptive document that discloses the compensation that is being paid to finders;

5) the customers must provide written acknowledgement to the FINRA member of the existence of the compensation arrangement; and

6) the confirmation of each transaction indicates that a referral or finder's fee is being paid.

Several of these requirements may be difficult to satisfy rapidly. As a result, and for these foreign finders as well, it may be useful to have an appropriate internal lawyer or available external counsel who can quickly confirm to any interested FINRA members that the entity is not subject to registration as a broker-dealer.

Losing WKSI Status: Consequences for Structured Note Dealers

The SEC's rules that classify issuers are not always widely followed beyond the securities bar. However, one of the most active current debates about the federal securities laws concerns the potential loss of "well known seasoned issuer" (WKSI) status by large financial institutions as a result of becoming "ineligible issuers" and the SEC's policies as to granting waivers. Many of the issuers potentially affected by this debate are issuers of registered structured notes. As a result, this article discusses the steps that distributors of structured notes need to consider or take when one of their issuers becomes an ineligible issuer and a waiver is not granted.[17]

WKSIs and Ineligible Issuers

WKSIs enjoy certain privileges under the federal securities laws, including the ability to use an automatically effective shelf registration statement. This type of registration statement is not subject to prior review and comment by the SEC and helps issuers to enter the market more quickly and on a cost-effective basis.

However, what the SEC rules giveth, the SEC rules also may taketh. An issuer that is an "ineligible issuer" (see SEC Rule 405 for the definition) will cease to be a WKSI. A company can become an ineligible issuer under a variety of circumstances, including as a result of certain violations of the federal securities laws. It won't surprise the readers of this

[16] This provision provides that "A person is subject to a "disqualification" with respect to membership, or association with a member, if such person is subject to any "statutory disqualification" as such term is defined in Section 3(a)(39) of the [1934] Act."

[17] For the moment, we will resist the temptation to weigh in on the debate as to when the SEC should grant waivers from "ineligible issuer" status. We will also resist the temptation to discuss the relevant securities regulations in detail – for a more complete explanation of WKSI status and the treatment of ineligible issuers, please see our FAQ, "Frequently Asked Questions About Shelf Offerings," which may be found at the following link: http://media.mofo.com/files/Uploads/Images/FAQShelfOfferings.pdf.

publication that, notwithstanding significant institutional efforts to comply with these laws, in the context of a large diverse financial institution, violations can arise that result in ineligible issuer status.

Limited Content of FWPs – Form of Red Herring

Free writing prospectuses (FWPs) became permissible in December 2005, following the SEC's "securities offering reform" rule-making process. In the structured note industry, market participants have become quite accustomed to using these rules to create a variety of marketing materials, including short-form red herrings, detailed term sheets, and product brochures, which were prohibited under the old rules. However, Rule 164, which provides the framework for the use of FWPs, significantly limits their use by ineligible issuers. Specifically, ineligible issuers are only permitted to use FWPs that set forth the terms of an offering. The use of detailed FWPs is prohibited for ineligible issuers. This restriction applies not only to materials prepared by the issuer itself, but also to other offering participants, such as underwriters and dealers. As a result:

- many types of marketing materials for structured products become off-limits for an ineligible issuer and its distributors; and
- ineligible issuers are forced to revert to the "traditional" long form "preliminary pricing supplements," with the issuer's robust base offering documents attached.[18]

The timing of ineligible issuer status is important here. For purposes of Rule 164, the "ineligible issuer status" is assessed at the time that a new offering is commenced. Accordingly, this facet of ineligible issuer status − the loss of the use of many FWPs − will typically come into play more quickly than the requirement to amend a shelf registration statement, as described in the next section.

Distributors of products offered by these issuers are encouraged to review their marketing materials to ensure that they comply with the applicable requirements. Dealers may also be subject to contractual restrictions that will expressly limit their ability to create materials that conform to the now reduced content restrictions of Rule 164 that are applicable to ineligible issuers.

New Shelf Registration Statement

Once an ineligible issuer files its first annual report with audited financial statements, it will cease to be able to utilize its automatically effective WKSI shelf registration statement. In a "Compliance and Disclosure Interpretation," [19] the SEC provided a bit of a remedy to smooth the transition from the automatically effective registration statement to a traditional non-WKSI registration statement. That is, when the issuer becomes an "ineligible issuer," it may file an amendment to its existing WKSI shelf on the form that it is then eligible to use – typically, Form S-3 (for U.S. issuers) or Form F-3 (for non-U.S. issuers).

For most financial institution issuers, the non-WKSI form of Form S-3/F-3 will not differ much from that of a WKSI shelf registration statement. However, when taken together with the required legal opinions, auditor consents, and other required exhibits, the preparation and filing of the new registration statement is not an insubstantial undertaking and requires careful planning. In addition, at some point after the new shelf is filed, many issuers will restate their "MTN prospectus supplement" and structured note product supplements to reflect the filing of the new shelf registration statement, as well as make a variety of related changes to their red herrings and final pricing supplements to reflect the filing and its contents. For underwriters, amendments to their existing program agreements with the relevant issuer which relate to ineligible issuer status are likely to be required and negotiated between the parties.

As a result, in connection with the new registration statement filing, distributors should review the materials that they use, both internally and with investors, that describe the relevant issuer's disclosure documents. These will likely require updates to match up with the issuer's new base prospectus and related documents.

[18] These longer documents are filed with the SEC under Rule 424(b) (which is used for statutory prospectuses), as opposed to Rule 433 (which is used for free writing prospectuses).
[19] See Compliance and Disclosure Interpretation No. 198.03, available on the SEC website.

Attorney Advertising

A Brief Note on Canadian Issuers

Every cloud has a silver lining, at least, sort of. Canadian issuers that file registration statements in the United States under the Multi-Jurisdictional Disclosure System (MJDS)[20] are not eligible to be WKSIs. These Canadian issuers were not necessarily pleased in 2005 when the new rules did not provide to them the benefits of a WKSI shelf. However, if such an issuer were to become an ineligible issuer, it would not need to re-file its shelf registration statement. On the other hand, such a Canadian issuer and its distributors would be subject to the limitations on the use of FWPs under Rule 164 that apply to ineligible issuers.

Conclusion

Ineligible issuer status will significantly impact the documentation used in connection with structured note and other registered securities offerings. When apprised of an upcoming development of this nature, distributors will need to review carefully their suite of offering documents in order to carefully plan their upcoming offerings and to make any necessary changes.

Contacts

Bradley Berman
New York
(212) 336-4177
bberman@mofo.com

Lloyd S. Harmetz
New York
(212) 468-8061
lharmetz@mofo.com

Anna T. Pinedo
New York
(212) 468-8179
apinedo@mofo.com

Jeremy C. Jennings-Mares
London
+44 (20) 79204072
jjenningsmares@mofo.com

Peter J. Green
London
+44 (20) 79204013
pgreen@mofo.com

Claire E. Logan
New York
(212) 336-4125
clogan@mofo.com

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

Morrison & Foerster has been named Structured Products Firm of the Year, Americas, 2014 by *Structured Products* magazine for the sixth time in the last nine years. See the write-up at http://www.mofo.com/files/Uploads/Images/120530-Americas-Awards.pdf. Morrison & Foerster named Best Law Firm in the Americas, 2012, 2013, and 2014 by *Structured Retail Products.com*.

Morrison & Foerster was named Legal Leader, 2013 by *mtn-i* at its Americas Awards. Several of our 2015 transactions were also granted awards of their own as a result of their innovation.

Morrison & Foerster was named European Law Firm of the Year, 2013 by *Derivatives Week* at its Global Derivatives Awards.

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life sciences companies. We've been included on *The American Lawyer*'s A-List for 11 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com. © 2015 Morrison & Foerster LLP. All rights reserved.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

[20] For more information about MJDS, please see our FAQ, "Frequently Asked Questions About the Multi-Jurisdictional Disclosure System," which may be found at the following link: http://media.mofo.com/files/Uploads/Images/FAQs-Multijurisdictional-Disclosure-System.pdf.