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Structured Thoughts

News for the financial services community.

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OCIE Issues Risk Alert Relating to Structured Note Sales

Earlier this year, the SEC's Office of Compliance Inspections and Examinations (the "OCIE") indicated branch offices and structured products as two of its priorities.[1] As one consequence of this focus, in an August 2015 risk alert, the OCIE identified several deficiencies in the controls that certain branch offices had put into place in connection with sales of structured notes.

The full risk alert may be found at the following link: http://www.sec.gov/about/offices/ocie/risk-alert-bd-controls-structured-securities-products.pdf

In its examination, the OCIE sought to determine whether these firms effectively supervised and monitored activities and risks associated with sales of structured notes to retail investors. The OCIE indicated that its analysis revealed discrepancies in the practices within each firm and discrepancies in the effectiveness of the controls.

The report does not necessarily shed any light on the practices of any institutions as a whole, but does indicate that some institutions have not have a uniform degree of compliance across their branches.

Scope of Review

In connection with the risk alert, the OCIE examined ten branch offices. Their identity, size and significance were not disclosed in the risk alert. However, the OCIE noted that one or more of them were affiliated with structured note issuers. The examination related to a variety of types of structured notes, but not exchange traded notes.

[1] See the OCIE's examination priorities statement for 2015: http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf

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The review period was generally January 1, 2011 to December 31, 2012. Accordingly, the issues discussed in the risk alert may not reflect the current operations of the examined branch offices, or the industry as a whole. Many broker-dealers have undertaken significant additional compliance efforts during the past several years.

Methodology

The OCIE analyzed 26,600 note sales, with a notional amount of more than $1.25 billion.[2] The OCIE reviewed the account documentation of the relevant customers, including data on risk tolerance and investment objective, age, and any approval for options trading. The OCIE reviewed:

- the predominant types of customers that had purchased these notes at each firm and branch office;
- resales of the notes in these accounts in order to gauge the frequency and price at which the notes were resold prior to maturity; and
- the frequency with which each firm's transactions exceeded internal policies and procedures governing suitability, as well as supervisors' documentation approving overrides of internal suitability guidelines.

The OCIE sought to employ data analytics in connection with its review. The analysis identified the predominant types of customers that purchased structured notes at each firm and branch office, and the OCIE further scrutinized branch offices and representatives that had made high numbers of sales. For example, in the case of one broker, the OCIE observed that the firm sold more structured notes in its most conservative investment objective category than it did to customers in its most aggressive investment objective category, by almost a nine-to-one margin.

Deficiencies Identified

The OCIE indicated that it had found deficiencies in the areas of suitability and supervision with respect to *all* of the relevant firms' note sales to retail investors. According to the OCIE, these firms:

- did not maintain or enforce adequate controls relating to determining the suitability of the note recommendations; and
- did not conduct both compliance and supervisory reviews of registered representatives' determinations of customer suitability, as was required by their internal controls.

The OCIE noted that all of the firms in question had policies and procedures governing suitability, processes for product development and approval, and training of representatives. The OCIE apparently did not review or comment on the adequacy of these policies and procedures. Rather, the OCIE found instances in which these controls were inadequately or inconsistently implemented.[3]

The OCIE identified two firms in which there was significant structured note activity in the accounts of elderly customers, and in the accounts of customers for whom the firm did not have any age information. One of the firms apparently did not collect information about customer age, meaning that representatives could not consider that information when making a suitability determination, which would call into question the adequacy of the determination.

A Few Noted Practices

Several of the practices discussed would be problematic as to the sale of virtually any investment product:

- The OCIE identified e-mails indicating that representatives were appearing to mischaracterize the attributes of the products in light of the goals of the investors, particularly to investors that did not speak English.
- The OCIE identified a firm in which representatives had retroactively changed customers' investment objectives in their account documentation, without the customers' approval, in order to justify concentrated positions of structured products.

[2] The report suggests that the most frequently sold type was the so-called "trigger phoenix," with contingent payments of periodic interest, and the potential for loss of principal at maturity.
[3] Hence the old mantra, "good to have good policies, even better to follow them."

Supervision

The OCIE reported that *all* of the examined firms did not enforce their written supervisory procedures (“WSPs”) relating to reviews of suitability determinations. [4] In addition, the implementation of the firms’ review procedures was not consistent across firm branches.

The risk alert provides only one example. At one branch, a majority of structured note purchases exceeded the firm’s concentration guidelines. The firm had a system to alert representatives and supervisors of breaches of concentration guidelines, which required a review and documentation of the reasons for an override of the firm’s guidelines. However, in this case, all of these transactions were approved by the branch manager or complex risk officer with little or no documented explanation, other than generic approval language.[5]

Resales at a Loss

The OCIE’s review of trading history indicated that a significant number of investor sales of structured products during the two year review period resulted in a loss. Focusing on “reverse convertible notes,” the OCIE found that the branch offices examined liquidated almost 25% of the purchases that representatives had sold to their customers. Over 35% of these liquidations were at prices below 80% of the principal amount.[6] (The report does not note what amounts were paid on these notes at maturity, or whether an investor in these products would have lost principal at maturity.)

Conclusion

In connection with the risk alert, the OCIE reminded brokers to take note of the importance of the implementation of controls, as well as their design, on the effectiveness of these controls. The OCIE expects that this risk alert will raise awareness of certain types of weaknesses, in order for brokers to consider them in their own compliance programs. The report reminds us that, even with proper policies and WSPs, consistent implementation remains important to the industry’s regulators.

FINRA Fines Broker-Dealer Over Institutional Communications and Representative Training

Introduction

Sometimes, even the biggest worry warts among us would like to let our guard down a bit. We’d like to think that there are some contingencies at to which we need not be that concerned. We’d also like to think that some documents are a less likely source of trouble than others.

Unfortunately, the world doesn’t always work that way. An August 2015 FINRA consent agreement, which resulted in a censure and fine of a broker-dealer, is a useful reminder that:

- Contingencies that can result in an adverse outcome to investors must be properly disclosed, and registered representatives should be made aware of them in order to advise their clients properly.
- Even “broker-dealer” only communications can turn raise concerns for a broker if the materials are not deemed fair and balanced or sufficiently robust.

Background – An Unexpected Redemption

The recent FINRA action arose from allegedly unsuitable recommendations made over a seven-year period in which the broker offered a trust security. The trust security represented an interest in (a) a capital security issued by an unaffiliated

[4] See footnote 3 above.
[5] In contrast, to the OCIE’s apparent satisfaction, branch managers and complex risk officers in the firm’s other branches who had approved overrides typically prepared lengthy and specific descriptions of their reviews, and the reasons for the overrides.
[6] According to the report, 28.4% of the sales were at a price of between 80% and 100% of the principal amount. 35.8% of the resales were for a price that exceeded the principal amount. More granular slicing of the amounts may be of interest to some. For example, in the 80% to 100% category, some of the purchase prices may not represent much of a loss, but may simply represent the discounting of the future interest payments, adjusted downward due to the possible loss of principal at maturity.

bank holding company and (b) a related interest rate swap contract. The trust security would pay a variable rate of interest that was subject to a minimum and a maximum rate.

The trust was subject to early termination under a variety of circumstances, including the redemption of the underlying capital security. Upon such a termination, the investors' redemption proceeds could be reduced by a "swap termination fee." At the time of issuance, the bank holding company wasn't expected to be able to redeem the capital security. However, as regulatory capital rules laws changed following the 2010 adoption of the Dodd-Frank Act, many relevant rules changed. And during the term of these instruments, sure enough, the bank holding company did in fact redeem its capital security. The trusts were terminated, and investors received redemption proceeds that reflected the deduction of the (significant) swap termination fee. As a result, investors lost a portion of the principal amount invested.

Unsuitable Recommendations and Insufficient Training

FINRA alleged that the broker's representatives were not properly educated as to the early redemption risk. Accordingly, they could not inform investors about the possibility of losses arising from the early termination. Under FINRA's guidance, in order for a member to been deemed to have discharged its reasonable basis suitability obligation, the member must perform appropriate due diligence to ensure an understanding of the product's potential risks and rewards, and must educate its registered representatives, about the characteristics and risks of each product before it allows registered persons to sell the product to investors.

FINRA also alleged that the broker failed to provide product specific training to its sales force, and that its internal-use only communications (discussed below) regarding the product failed to adequately describe the risks.

In light of the registered representatives' limited comprehension of the termination provisions and associated risks, FINRA concluded that the member firm lacked a reasonable basis for recommending the product.

Internal Communications

FINRA also concluded that the broker's internal-use only materials for the product were not fair and balanced, and that they failed to provide a sound basis for evaluating the risks of investing in the trust security. These materials were designed for broker-dealer use only, and did not disclose all of the risks of the security, including the risk of loss of principal arising in the case of an early redemption. Although these materials did include some key risk factors, they did not identify the risk relating to early redemption, which turned out to be the one that resulted in significant investor losses.

NASD Rule 2211(d), which was in effect prior to FINRA's revisions to its communication rules in 2013, required that "institutional sales material," which included internal-use only material, meet the content standards applicable to communications with the public under former NASD Rule 2210(d). NASD Rule 2210(d)(1), in turn, provided that subject communications "shall be based on principles of fair dealing and good faith, must be fair and balanced and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry or service."

To the extent that the broker's materials did not include adequate disclosures about the possible loss of principal upon an early redemption, FINRA concluded that these materials were inadequate.

Conclusion

Drafting risk factors always involves a degree of judgment. Practitioners consider a variety of factors in drafting risk factors, including materiality, the probability of occurrence, and the intended audience of the communication. FINRA's recent action is a reminder to parties to err on the side of caution in this area.

PRIIPs Technical Discussion Paper

The three European Supervisory Authorities ("ESAs") are responsible for drafting various technical standards in relation to the PRIIPs regulation (Regulation (EU) 1286/2014) (the "Regulation"), for consideration by the European Commission. At the end of June 2015, the ESAs published a technical discussion paper, which focused on the possible methodologies for presenting some of the key indicators required to be contained in a Key Information Document ("KID") under the Regulation, namely risk indicators, performance measures and costs.

The ESAs do not set forth any firm recommendations at this stage. Instead, they are more interested in market views and feedback on the options presented in the discussion paper.

Types of Risk. In relation to the presentation of risk indicators, the focus is on three key areas of risk – market risk, credit risk and liquidity risk. The ESAs have narrowed down the possibilities to what they consider to be the four viable options:

1. a qualitative based indicator, combining both credit risk and market risk;
2. an indicator which separates market risk (in respect of which a quantitative measure of 1-7 could be applied based on volatility) and credit risk (where a qualitative measure, rated A-G based on external credit ratings could be applied);
3. an indicator based on quantitative market and credit risk measures, calculated using forward-looking simulation models; and
4. a two-level indicator in which the first level would distinguish between products in a very broad manner (e.g., those where capital is at risk versus those which have capital protection), while the second level would provide investors with more granular insight into information provided in the first level. The first level might differentiate based upon product characteristics, while the second level might differentiate based on quantitative measures.

The second option has the support of the Structured Products Association in the UK. However, the Regulation itself refers to a “summary risk indicator” in the *singular*, and the ESAs state that they are still discussing whether a separate statement of market and credit risk would satisfy this requirement. The third option has the support of the German structured products industry (among others), with one possible approach within this third option being based on an approach used by the German industry since 2005.

Performance Risks. In relation to performance, different possibilities are provided to demonstrate how a PRIIPs manufacturer could potentially represent the performance of their structured product in a KID. One possibility is a “what-if” scenario, which would show the investor what could happen to the product under certain pre-determined market conditions. Within this scenario, there is the possibility either of permitting the manufacturer to determine what the scenarios should be, or alternatively, for the ESAs to prescribe the scenarios for use by all manufacturers for all types of products. Another approach is the so-called “probabilistic approach”, which involves defining the scenarios in accordance with the likelihood of the possible returns. A third option is to combine the first two approaches.

Investor Costs. In relation to costs, the discussion paper follows two primary considerations – firstly the identification of the different types of costs which are applicable to PRIIPs products, and secondly, developing appropriate methodologies for aggregating identified costs, so that they can be presented in the form of a single overall cost ratio (or a summary cost indicator).

Since the cost components of structured products are often embedded within the product’s purchase price, the ESAs consider that there are two different possible approaches – firstly to introduce a distinction between the price of the investment and the margin/fees incorporated in the price (such as sales commission and structuring costs), or secondly to make disclosure of costs based upon the “fair” or “intrinsic” value of the product, i.e. the value of the liability on the manufacturer’s balance sheet when the product is sold. Needless to say, the second approach is similar to the approach adopted in 2013 by the U.S., and more recently, by Canadian regulators.

The ESAs have identified the following types of costs as being potentially relevant – entry costs, ongoing costs, exit costs, early redemption costs, and possibly other costs –An example, the ESAs suggest, is the loss of interest on the amount invested between the purchase date and the commencement date for the product (as is relevant to the purchase of virtually any debt security).

In terms of aggregating the costs to create one or more cost indicators that would aid comparison of products, the ESAs have suggested two possibilities – firstly a total cost ratio, where the costs of operating the product are aggregated and presented as an annual percentage rate on the investment, or secondly, showing the reduction in yield, which is a method of expressing the overall impact of total costs in terms of their reduction in the gross yield of a product.

What’s Next. The ESAs intend to carry out a final consultation, setting out their proposed draft Regulatory Technical Standards, in autumn 2015. Following this, they will finalise and submit the draft Regulatory Technical Standards to the European Commission by 31 March 2016. The Regulation will take effect at the end of 2016.

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Who Owns this FWP?

Introduction

Free writing prospectuses (FWPs) were first permitted under the SEC rules in December 2005. No industry has benefitted from them as much as the structured products. From red herrings, to term sheets, to product brochures, issuers, underwriters and downstream broker-dealers prepare a variety of materials designed to help investors understand how the products work, and their potential risks and benefits.

Of course, FWPs were new in 2005. Lawyers and others immediately asked the question, “who will be liable for the contents of the FWP?” The question remains important in the structured products industry, as different parties may have different degrees of involvement in their preparation. The issuer and the underwriter may work together on creating an FWP that operates as a red herring for the offering. But the issuer and underwriter don’t always know in all cases what marketing materials may be in use by downstream distributors.

The article describes the relevant SEC rules, identifies the remaining areas of uncertainty, and describes a number of contractual provisions and other practices that have been used by market participants to address these issues.

Liability and FWPs

The SEC attempted to address questions about FWP liability by adopting Rule 159A. This rule addresses what are sometimes referred to as “cross-liability issues.” The rule provides that an offering participant other than the issuer will not be deemed to offer or sell securities to a person “by means of” an FWP unless:

- the offering participant used or referred to the FWP in offering or selling the securities;
- the offering participant offered or sold the securities and participated in planning for the use of that FWP by other offering participants, and the FWP was used or referred to in offering or selling securities by one or more of such other offering participants; or
- the offering participant is required to file the FWP with the SEC under Rule 433.

Rule 159A also provides that a person will not be considered to have offered or sold securities by means of an FWP solely because another person has used or referred to the FWP or filed it with the SEC.

As to issuers, Rule 159A provides that an FWP is deemed to be made by or on behalf of an issuer if the issuer or an agent or representative of the issuer authorizes or approves the information or communication before its provision or use.

Remaining Uncertainties

Within this framework, a variety of uncertainties remain, including as to the provisions of Rule 159A. For example, what sort of involvement in the drafting of a document constitutes “participating in the planning for the use of an FWP”? Discussing the contents and format? Being included in an e-mail distribution of drafts of the document? Commenting on the document, or indicating that one has no comments on the document?

Practical Responses

In practice, market participants respond to this regulatory structure with a variety of contractual provisions and practices.

Issuers and Underwriters. Issuers and underwriters will be parties to an underwriting agreement or program agreement. As a starting point, in order to protect both parties, the agreement will typically include restrictions that bar each side from preparing FWPs without the other party’s approval. This type of provision is designed to ensure that both the issuer and the underwriter can review any relevant FWP, and understand how it will be used. However, there are a variety of circumstances under which it may not be practical or desirable for an underwriter to be required to submit an FWP to an issuer for approval. For example, in the case of an active note program, with frequent investor inquiries and negotiations, it may not make sense for an issuer or its counsel to review all preliminary term sheets that are proposed or negotiated. That is, requiring review by the issuer or its counsel may not help at all to facilitate, and could even impede, the execution of reverse inquiry and similar transactions on a timely basis. Such provisions may also result in relatively significant time and expense in connection with preliminary term sheets for various proposals that don’t result in actual transactions.

Similarly, an underwriter with a multi-issuer structured notes platform may have a variety of FWPs that are generic marketing materials that relate to its platform, and which do not contain any material information about any particular issuer. These materials will also not be furnished to any investor without the robust red herring for the actual live transaction, so they tend to be of less interest to any specific issuer.

For these categories of FWPs, and where the underwriter is deemed to have sufficient expertise in the area, an issuer may be willing to provide advance permission to create and distribute these types of materials.

Selling Group Members. The situation with respect to distributors that are not in privity of contract with the issuer can be more fluid. The practices of these entities may vary. For example, some of these entities may sell the securities directly to end-investors; some may sell them to other dealers for further distribution, while others may sell the securities to a combination of the two. Some distributors may be perfectly happy to use only the offering materials prepared by the issuer and the lead underwriter; however, others may seek to prepare materials of their own. In addition, some brokers may have a more established track record than others in working on these types of offerings, and greater familiarity with the laws and practices that apply to FWPs. Accordingly, a greater variety of practices may exist as to the circumstances under which these entities may be permitted to create their own FWPs.

As a starting point, most underwriters will have provisions in their “selected dealer agreements” or similar documents that prohibit the selling group members from creating the members’ own marketing materials. Those dealers who don’t prepare their own marketing materials, will often be content to simply execute the document on that basis. However, what happens in the case of a dealer that does in fact plan to create its own marketing materials about the relevant offering?

- The lead underwriter and the dealer may agree that the lead underwriter will have the right to review and approve of those materials. Due to the potential liabilities discussed above, that underwriter may do so only reluctantly, with a view to potentially limiting its own exposure in the event that any aspect of that document is incorrect.
- The lead underwriter may grant the dealer limited permission to create its own FWPs, such as term sheets that are limited to the economic terms of the offering, and that include only content that is in the red herring provided by the issuer and underwriter.
- The lead underwriter may request indemnification (both for itself, any other underwriters and perhaps the issuer) with respect to any misstatements in that document.

Impact of FINRA Filing Rules. In the past few years, FINRA’s revisions of its communications rules encouraged many underwriters to attempt to have issuers take ownership of certain types of FWPs, and file them with the SEC. Specifically, FINRA’s revised filing rules relating to communications, which went into effect in 2013, required a variety of types of structured note FWPs used by broker-dealers to be filed with FINRA’s advertising department. One type of document exempted from the filing requirements was an FWP filed by an issuer under Rule 433. Accordingly, several underwriters adopted a practice of having preliminary offering materials, such as detailed term sheets, filed by the issuer on the EDGAR system.

* * *

At the start of each new distribution relationship, and sometimes, at the start of each offering, the parties will need to understand what types of documents are planned, and who is creating them. By doing so, uncertainty as to who must review them, who must file them, and who is ultimately responsible for them, can be best avoided.

FINRA Initiates Sweep Relating to Compensation Practices

In August 2015, FINRA sent to members a “sweep letter” requesting a broad range of information as to their broker compensation practices and supervision. In the letter, FINRA indicates that its intent is to “continue [its] assessment of the efforts employed by firms to identify, mitigate and manage conflicts of interest, specifically with respect to compensation practices.”

The text of the letter, and a summary of its requests, may be found at the following link on the FINRA website: http://www.finra.org/industry/conflicts-interest-review-compensation-and-oversight. For additional discussion, please see our article, which may be found at: http://www.bdiaregulator.com/.

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IRS Releases Notices Designating Certain "Basket Contracts" as Listed Transactions and Others as Reportable Transactions of Interest

In July 2015, the IRS released two notices addressing "basket contracts." Generally, these are derivative instruments linked to a basket of reference assets that, among other things, allow the holder to vary the basket over the instrument's life. According to the IRS, these types of contracts have the potential for tax avoidance, because taxpayers account for gain or loss on the contract once the contract terminates, and not when changes to the underlying assets are made. This may result in deferral and conversion of short-term capital gain into long-term capital gain and other tax discontinuities.

The two notices denominate certain basket contract transactions as "listed transactions," and others as "transactions of interest."

For a more detailed discussion, please see our August 2015 edition of "Tax Talk", which may be found at: http://www.mofo.com/~/media/Files/Newsletter/2015/08/150806TaxTalk.pdf

Cheat Sheets

We have produced a few quick reference summaries of various regulations that may be of interest to readers. These are accessible from the following links:

Liquidity Coverage Ratio (as applicable to U.S. banks)

The G-SIB Buffer

The FSB TLAC Proposal

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Morrison & Foerster was named Best Law Firm for Derivatives – US, 2015 by *GlobalCapital* at its US Derivatives Awards.

Morrison & Foerster has been named Structured Products Firm of the Year, Americas by *Structured Products* magazine six times in the last ten 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, 2014 and 2015 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.

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