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Structured Thoughts

News for the financial services community.

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FINRA Revises its Proposed Amendments to Rule 2210

In our recent Client Alert, we wrote about the Financial Industry Regulatory Authority, Inc.'s proposed changes to Rule 2210, Communications with the Public.[1] One of the proposed amendments was to change the pre-use filing requirement in Rule 2210(c)(1)(A) applicable to new member firms to, in large part, a concurrent with use requirement (within 10 business days of first use). This filing requirement applies to retail communications used in electronic or other public media by member firms within one year of the effective date of their FINRA membership. Under the original proposed amendments, new member firms would only have to make a pre-use filing of their website and material changes to their website.

In response to comments received, FINRA filed a Partial Amendment No. 1 to its original proposal on September 1, 2016, and the Securities and Exchange Commission approved the proposal, as modified by Partial Amendment No. 1, on an accelerated basis on September 13, 2016.[2] The public is invited to comment on the revised proposal through October 11, 2016.

The only change to the previous proposed amendments was a decision by FINRA not to amend the pre-use filing requirement of Rule 2210(c)(1)(A), which will remain in its current state. FINRA decided to defer changes while it accumulates more data on the frequency and types of revisions required for new member retail communications.

[1] The Client Alert on the proposed amendments to Rule 2210 is available at: https://media2.mofo.com/documents/160606finracommunicationsrules.pdf.
[2] FINRA's Partial Amendment No. 1 can be found at: http://www.finra.org/sites/default/files/SR-FINRA-2016-018-amendment-1.pdf; the SEC's approval order can be found at: http://www.finra.org/sites/default/files/SR-FINRA-2016-018-approval-order.pdf.

The SEC Takes Action on Structured Product Training Materials

Introduction

In September 2016, the SEC instituted administrative proceedings against a broker-dealer, alleging that the broker's internal training materials used for certain structured notes were insufficient.[3] The action principally relates to the broker's training of its registered representatives as to "reverse convertible notes" and similar securities linked to single stocks.

In evaluating the broker's training materials, the SEC noted that many of the securities in question were recommended by the broker to retail investors who had limited investing experience, only modest income and net worth, and moderate or conservative investment objectives. These investors included a number of retirees. Accordingly, the retail nature of these offerings appears to have contributed to the degree of scrutiny that the SEC applied.

In connection with the order, the SEC did not identify any issues with the prospectuses or other offering documents provided to investors; rather, the action challenged the broker's education and training. The SEC concluded that certain registered representatives did not properly understand certain aspects of the notes and, therefore, did not always form a reasonable basis to determine whether they were suitable for certain customers.

The action rests largely on Section 17(a)(3) of the Securities Act's prohibition on engaging in a course of business that operates or would operate as a fraud or deceit upon the purchaser in the offer or sale; in this type of action, simple negligence may be sufficient to seek damages against a defendant, even without scienter.[4]

Describing the Options and Volatility

Like other structured notes, the pricing of reverse convertible notes depends upon one or more derivatives. The SEC pointed out that, when the broker-dealer's desk solicited competitive bids from issuers to issue these notes, it described the derivative from what it characterized as "the investor's perspective," in order to avoid confusion on the part of the issuer as to the product on which it was bidding.[5] In the action, the SEC also focused on the manner in which a stock's implied volatility played a role in the broker's policies and practices of selecting underlying stocks. The broker selected underlying stocks that had sufficient volatility to generate attractive coupons for its investors, and appropriate downside market protection levels.

Inadequate Education and Training?

The SEC pointed out that the broker's internal education and training primarily focused on describing the notes' payouts and other terms. However, the SEC alleged that these materials did not describe the option from the investor's perspective in the same manner as the summary information provided to issuers in the correspondence described above. In addition, the broker's educational materials did not describe sufficiently the role of volatility and the potential for breach of the notes' barrier in the broker's selection of the underlying stocks. Accordingly, the SEC concluded that the broker's registered representatives were not adequately educated and trained to understand the risk and characteristics of the product and, therefore, not necessarily positioned to make appropriate representations of these products.

Takeaways

This action is largely rooted in the discrepancy in how the broker described the relevant products in some communications, but not in its training materials. That is, the concepts of "optionality" and "volatility" were addressed in some of the broker's materials, but not the training materials. In this regard, the SEC has shown a readiness to identify these types of discrepancies, and to consider them as evidence of inadequacies. Accordingly, brokers are encouraged to have another look at their own training materials to consider whether, among other things, they reflect the key aspects of their products that may appear in their other materials. Needless to say, to the extent that they played a role in the

[3] The SEC's order may be found at the following link: https://www.sec.gov/litigation/admin/2016/34-78958.pdf.
[4] We discussed the negligence standard in a recent issue of this publication: https://media2.mofo.com/documents/160811structuredthoughts.pdf.
[5] As many readers of this publication know, this is not an uncommon practice, in part because many working group members may have a background in derivatives, as opposed to debt offerings or other securities. Some of the e-mail traffic in a structured note offering may contain references to the types of options that are embedded in a note. And due to the SEC's requirements as to disclosures of "estimated values," a discussion of the derivative component of structured notes appears in most offering documents.

SEC's action, the concepts of option pricing and volatility are useful places to start; however, they are certainly not the end of the inquiry.

Once information is set forth in a broker's training materials, the question will of course arise whether that information is sufficiently material to also belong in the relevant offering documents for a structured product. Otherwise, a regulator can make an argument that is similar to that of this reverse convertible note action: "If the information is in the training materials, why wasn't it provided to investors as well?" Of course, further loading offering documents with additional information may further complicate otherwise lengthy materials, rendering them less useful for investors at the end of the day, and perhaps less likely to be read. However, to the extent that a regulator views differing descriptions as evidence of an inadequacy, some market participants may be willing to make those types of additions or revisions.

The NASAA 2016 Enforcement Report and Structured Products

Overview

The North American Securities Administrators Association (NASAA) Enforcement Report provides an overview of state enforcement efforts for the 2015 fiscal year. The goal of NASAA's members is to identify misconduct and to take action against violators of the laws in order to protect the integrity of the markets. In 2015, state securities regulators brought more than 2,000 enforcement actions against over 2,700 respondents. The vast majority of these actions were administrative in nature (1,630 actions), followed by criminal (253 actions), civil (152 actions), and other (39 actions).

Types of Relief

There are a number of types of relief that NASAA's U.S. members can impose. One form of relief is monetary sanctions. More than half of the sanctions for the 2015 fiscal year required restitution, totaling $538 million. Other forms of monetary relief include fines and penalties, investor education, and costs.

A second form of relief imposed by NASAA's U.S. members is criminal sanctions. The majority of those incarcerated for violations of securities regulations received sentences that combined resulted in 849 years of jail time. Along the same lines as criminal sanctions, state securities regulators were able to deny or limit the activity of licenses and registrations of law breakers. While some individuals had their licenses merely suspended, revoked, or denied, most individuals had their licenses withdrawn as a result of state action.

Structured Products

So how do structured notes fit into this equation? In 2015, the most reported products and schemes are those that many would expect: Ponzi schemes, real estate investment program fraud, oil and gas investment program fraud, Internet fraud, and affinity fraud. However, state securities regulators launched numerous investigations into structured products as well. Accordingly, market participants pay significant attention to state law and the activities of state securities regulators, in addition to the regulatory structures imposed by the SEC and FINRA.

People Targeted by Fraudsters

The study shows that particular categories of vulnerable adults, primarily senior investors, were targeted by fraudsters disproportionately. Often, this fraud was perpetrated by use of the Internet. Others used the Internet to target a different age range, single women, through Internet dating. In one case highlight, an individual operated a "sweetheart" investment scheme with more than 30 victims that he met through online dating services.

The case also highlights "gatekeeper fraud," which is a fraud that is perpetrated by an intermediary who is supposed to provide an important service to benefit investors. In one example, an estate planning attorney used his position of trust as a lawyer to gain the confidence of elderly victims and perpetrate a fraudulent scheme that totaled approximately $10 million.

Types of Respondents

A large percentage of the enforcement actions brought by NASAA's U.S. members in 2015 involved unregistered individuals and unregistered firms. Notably, more registered members of the industry were named as respondents than unregistered members for the first time since NASAA began conducting enforcement surveys. For instance, in 2015 NASAA's U.S. members brought enforcement actions against 812 registered industry members, while they brought

enforcement actions against 791 unregistered industry members. Whether the number of registered industry members involved in enforcement actions will continue to climb, how this will impact the securities markets in the coming year, and how NASAA will respond remain to be seen.

Real Estate Shares Form Own Sector

Effective August 2016, the Global Industry Classification Standard (GICS) was updated to create a new sector for real estate companies. "Real estate" was moved from under the "financials sector," and promoted to its own sector. The Real Estate Investment Trusts Industry was renamed "Equity Real Estate Investment Trusts." (Mortgage REITs will remain in the financials sector under a newly created industry and sub-industry called "Mortgage REITs.")

The GICS system is managed by MSCI Inc. and S&P Dow Jones Indices LLC.

The change will impact the composition of indices and stock baskets that are created around the relevant GICS, including how they are described in relevant offering documents and related risk factor disclosures. Some analysts also expect that the change may result in increased interest from many retail investors in the REIT sector, due to its increased prominence.

Building a Better Redemption Provision

The issuer call provisions in many exchange traded notes (ETN) work like this: Once the call notice is issued, the "valuation date" for the ETN will be next business day, and the ETNs will be redeemed on the third business day after the valuation date. All well and good, and all will be fine if the person who drafted the underlying documents for the ETN took into account the indenture provisions relating to redemptions. If not, there may be a few obstacles to overcome before the ETN issuer may send out its call notice.

Indenture Redemption Provisions

The minimum standard notice timing under a typical open-ended indenture is 30 days from the date of the call notice to the redemption of the notes. Consequently, prior to issuing redeemable notes with a shorter time period requirement, such as ETNs, attention should be given to overriding this default provision.[6]

If the note is part of an existing series of notes under the indenture, such as a series of medium-term notes, then the issuer will be relying on its existing board resolutions, rather than having a special meeting to issue the redeemable note. Under a typical indenture, the place to specify the terms of the note and to clarify the required redemption timing would be in an officers' certificate. When drafting that certificate, one should avoid simply defaulting to the indenture redemption provisions by including a statement such as "the notes are subject to redemption as provided in Article [ ] of the indenture." That type of drafting may immediately set up a conflict between the indenture redemption timing provisions and any shorter timing requirement included in the note itself.

Most officers' certificates will have a "savings clause," under which, in the event of a conflict between the terms of the note as set forth in the prospectus and the terms of the officers' certificate, the prospectus will control. The neater solution is to match the redemption timing requirements in the officers' certificate to those in the note (or prospectus), thus avoiding reliance on the savings clause.

Board Resolutions

Under the redemption provisions in the indenture, the trustee will require receipt of either the board resolutions authorizing the redemption or the officers' certificate governing the terms of the note. If the note is listed, the relevant exchange will also require a copy of the board resolutions. With the board resolutions in hand, the trustee can determine whether the officers' certificate was properly executed by authorized officers under the board resolutions, and the exchange will be able to determine if the redemption has been duly authorized.

[6] A variety of other structured notes will raise similar issues, ranging from simple callable step-up notes to more complicated callable yield notes.

Most board resolutions for a shelf registration statement covering a continuous offering program under which many redeemable notes are issued are drafted very broadly, and authorize designated officers to take any actions deemed necessary or appropriate with respect to the securities. When preparing board resolutions, care should be taken not to limit the authority to actions in connection with the offer, issuance, and sale of the securities, as a trustee or the relevant exchange may question where a redemption fits into that formulation. That is, a redemption may be considered something occurring subsequent to the "offer, issuance and sale."

Of course, the answer to that argument will be that the redemption was contemplated when the terms of the notes were approved by an authorized officer at the time of their issuance. If the trustee requests an opinion of counsel in connection with the redemption, as they are authorized to do under the indenture, there will be less trepidation on the part of the opinion-giver if the redemption concept is more clearly set out in the board resolutions. This could be accomplished by authorizing, in the board resolutions, the authorized officers to take any actions deemed necessary or appropriate with respect to, ***or under the terms of***, the notes.

Upcoming Events

From MAD to MAR – The New EU Market Abuse Regime, Thursday, October 13, 2016
Morrison & Foerster Teleconference, 12:00 p.m. – 1:00 p.m. EDT

The coming into force of the EU's Market Abuse Regulation in July 2016 introduced many new obligations for issuers and arrangers of capital instruments, as well as changes to existing practices. The offences relating to insider dealing, "tipping off," and market abuse look familiar, but the scope of the market abuse regime has been broadened considerably compared to the previous Market Abuse Directive, both in terms of trading venues covered and as to the types of instruments captured.

As well as the market manipulation offences, speakers Peter Green and Jeremy Jennings-Mares will examine the key obligations for issuers, both EU and non-EU, in relation to the safeguarding, control, and disclosure of inside information and the requirements on their executives and managers and connected persons under MAR. We will also examine the scope of exemptions designed to allow legitimate market transactions, such as buy-backs, stabilization, and market-soundings, as well as "legitimate behavior" defenses.

To register or for more information, click here. *CLE credit is pending for New York and California*.

Derivatives Regulation Update: Latest U.S. Developments, Tuesday, October 18, 2016
Morrison & Foerster Teleconference, 12:00 p.m. – 1:30 p.m. EDT

In this session, speakers Julian Hammar and James Schwartz will review the latest developments in U.S. derivatives regulation, including:

- CFTC De Minimis Exception Developments;
- Uncleared Swaps Margin Rules Update;
- CFTC Position Limits Supplemental Proposal;
- CFTC Proposed Rules Regarding Registration Relief for Certain Foreign Persons and Annual Reports for Commodity Pool Operators;
- SEC Title VII Implementation;
- SEC Proposal Regarding Investment Companies' Use of Derivatives;
- Federal Reserve's Proposal to Further Limit FHCs' Commodities Activities; and
- Federal Reserve and OCC Proposed Rules for Financial Contracts of G-SIBs and Related Matters.

To register or for more information, click here. *CLE credit is pending for New York and California*.

FINRA Rule 2210 – Communications with the Public, Thursday, October 20, 2016
Morrison & Foerster Teleconference, 12:00 p.m. – 1:00 p.m. EDT

The FINRA communications rule governs all aspects of communications by member firms. FINRA is in the process of amending Rule 2210. In this session, speaker Bradley Berman will discuss:

- Upcoming amendments to Rule 2210;
- The scope of Rule 2210;
- FINRA enforcement actions relating to communications; and
- Social media use by broker-dealers and their associated persons.

To register or for more information, click here. *CLE credit is pending for New York and California*.

Structured Products Washington Conference 2016, Wednesday, November 9, 2016
Morrison & Foerster Sponsorship

The Washington Court Hotel
525 New Jersey Avenue NW
Washington, D.C. 20001

The 4th annual Structured Products Washington D.C. conference will be on November 9.

For more information, or to register, visit http://www.structuredproductswashington.com/.

Join our *Structured Thoughts* LinkedIn Group

Morrison & Foerster has created a LinkedIn group, *StructuredThoughts.* The group serves as a central resource for all things Structured Thoughts. We have posted back issues of the newsletter and, from time to time, disseminate news updates through the group.

To join our LinkedIn group, please click here and request to join or simply e-mail Carlos Juarez at cjuarez@mofo.com.

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Morrison & Foerster was named 2016 Global Law Firm of the Year by *GlobalCapital* for its Global Derivatives Awards.

Morrison & Foerster was named 2016 Americas Law Firm of the Year for the second year in a row by *GlobalCapital* for its Americas Derivatives Awards.

Morrison & Foerster was named the 2016 Equity Derivatives Law Firm of the Year at the *EQDerivatives* Global Equity & Volatility Derivatives Awards.

Morrison & Foerster has been named Structured Products Firm of the Year, Americas by *Structured Products* magazine seven times in the last 11 years.

Morrison & Foerster was named Best Law Firm in the Americas four out of the last five years by *StructuredRetailProducts.com*.

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