Morrison & Foerster News Bulletin Volume 7, Issue 3 March 3, 2016

Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Structured Product Sales at Bank Branches: Networking-Arrangement Rules

Many broker-dealers engaged in the structured products industry are affiliates of large U.S. banks, which have a significant customer footprint. When yields are low on conventional banking products, such as fixed-rate certificates of deposit or savings accounts, broker-dealers and bank customer relations specialists alike are especially mindful that structured products may be useful investments for some bank customers.

If broker-dealer services are offered on a bank's premises, or if bank employees refer bank customers to the broker-dealers, the participants must be aware of, and comply with, FINRA Rule 3160 and SEC Rule 701[1] of Regulation R, which govern these arrangements. In this article, we summarize some of the key provisions of these rules.

Scope of Regulation

Rule 3160 regulates "networking arrangements," in which a FINRA member conducts broker-dealer services on or off the premises of a financial institution. For example, a broker-dealer may utilize a portion of the space at a bank branch to offer its services. Alternatively, there may be a referral arrangement in place under which bank employees will refer customers to the broker-dealer, typically in exchange for a referral fee.

[1] For additional discussion of Regulation R and the limitations that it imposes, see our article, "Regulation R and Bank Sales of Structured Products," which may be found at: http://media.mofo.com/files/Uploads/Images/130412-Structured-Thoughts.pdf.

Identification of the FINRA Member

If a FINRA member conducts broker-dealer services on the premises of a financial institution, such as a bank branch, it must:

- clearly identify itself as the party providing the broker-dealer services;
- distinguish its broker-dealer services from the services of the financial institution;
- conduct its broker-dealer services in an area that clearly displays the FINRA member's name; and
- to the extent practicable, operate its broker-dealer services in a location that is physically separate from the routine retail deposit-taking activities of the financial institution.

These requirements are all designed to help ensure that a customer will not confuse the products and services offered to him or her by the broker-dealer with those of an FDIC-insured bank.

Written Agreement Between the Parties and Rule 701

Networking arrangements between a FINRA member and a financial institution, whether or not they are affiliated entities, must be governed by a written agreement. This agreement will set forth the responsibilities of the parties and their compensation arrangements; it must include all broker-dealer obligations required by Rule 701 of SEC Regulation R. The Regulation R obligations are imposed upon the FINRA member under Rule 3160, whether or not set forth in the written agreement.

Among other requirements of Rule 701, a referral fee cannot be paid by the broker-dealer to a bank employee unless the referred customer is a "high net worth customer" or an "institutional customer," as these terms are defined in Rule 701. Similarly, the broker-dealer must perform an appropriate suitability analysis as to the proposed transaction before paying the referral fee (or determine that the relevant customer has the ability to evaluate the relevant investment risk on its own, and is in fact exercising its independent judgment). Needless to say, for structured products, particularly those that are complex, the suitability analysis is likely to be more rigorous than that which may be undertaken for a more conventional financial product.

The written agreement must provide that the FINRA member's supervisory personnel, and any representatives of the SEC or FINRA, will be permitted access to the financial institution's premises where the member conducts broker-dealer services in order to inspect the books and records and other relevant information maintained by the member with respect to its broker-dealer services.

Rule 3160 requires the FINRA member to promptly notify the financial institution if any associated person of the FINRA member who is employed by the financial institution is terminated for cause by the member. This requirement will often be set forth in the networking agreement.

Required Customer Disclosures and Communications

Upon or prior to opening a customer account by the applicable FINRA member, the broker-dealer must disclose in writing to each customer that its broker-dealer services are being provided by the FINRA member and not by the financial institution, and that the "securities products" purchased or sold in a transaction are:

- not insured by the FDIC;
- not deposits or other obligations of the financial institution and are not guaranteed by the financial institution; and
- subject to investment risks, including possible loss of the principal invested.

These disclosures must also be made orally by the FINRA member for any customer account opened on the premises of a financial institution.

When the FINRA member provides confirmations and account statements, these must clearly indicate that the broker-dealer services are being provided by the FINRA member. In addition, "retail communications," including material published, or designed for use in media broadcasts, ATM welcome screens, billboards, signs, posters and brochures, that announce the location of a financial institution where broker-dealer services are provided by the member or that are distributed by the member on the premises of a financial institution must also include these disclosures.

As a result of these provisions, many structured note prospectuses include a prominent caption with these three key points where it is anticipated that the product may be offered on the premises of a financial institution that is party to a networking agreement.

These "legends" are not required for certain specified short-form presentations.

Limitations on Referral Fees

Rule 701 operates as a safe harbor for banks to be excluded from the Exchange Act's definition of "broker," even if a bank employee receives a referral fee for referring a high net worth customer or institutional customer to a FINRA member subject to a networking arrangement. Rule 701 does not specifically address networking relationships that do not involve a referral fee; however, the use of referral fees is typically an important incentive for bank employees to direct a branch customer to the relevant broker-dealer.

For purposes of Rule 701, a high net worth customer is one that has at least $5 million in net worth (excluding its primary residence and associated liabilities). An institutional customer is an entity that has: (a) at least $10 million in investments, (b) $20 million in revenues, or (c) $15 million in revenues if the bank employee refers the customer to the broker or dealer for investment banking services.

To receive that referral fee, the bank must have a reasonable basis on which to conclude that the customer is a high net worth customer. The relevant customer also must be notified that the bank employee is participating in an incentive compensation program for referring the customer, and the payment of this fee may be contingent on whether the referral results in a transaction with the broker-dealer.

Additional Requirements Applicable to Bank Employees

To qualify under Rule 701, the relevant bank employee:

- must not be registered or approved, or otherwise be required to be registered or approved, under the qualification standards established by an SRO, such as FINRA;
- must be predominantly engaged in banking activities other than making referrals to a broker or dealer;
- must not be subject to most of the statutory disqualifications provided by Section 3(a)(39) of the Exchange Act; and
- must encounter the relevant customer in the ordinary course of the employee's assigned duties for the bank.

Good Faith Compliance

Rule 701 includes a cure provision that may apply if the bank has not made the required determination as to one or more customers, *if* the bank has reasonable policies and procedures in place to comply with Rule 701.

The SEC Speaks, 2016: A Few Points Relating to Structured Products

In February 2016, representatives from a variety of divisions of the SEC presented at the annual "SEC Speaks" series of seminars organized by the Practising Law Institute. A number of their comments addressed the structured products market.

Chair Mary Jo White indicated that, in the enforcement arena, the SEC will focus on, among other things, "the structuring, disclosure, and sales of complex financial instruments." Chair White noted that in a variety of areas, the SEC would use its regulatory powers beyond the regulation of disclosures to fulfill its mission, including as a result of the complexity of today's financial products.

Commissioner Kara Stein devoted a significant portion of her remarks to ETFs, including the market volatility that this class of products witnessed in August 2015. Commissioner Stein noted that the complexity of some ETFs makes it difficult for the average investor to understand them.

She noted in her speech:

> Retail investors are being introduced to innovative ETFs that may offer attractive yield, but also feature more complex and other higher risk strategies. These may include currency hedged ETFs, smart-beta strategies, and bank-loan ETFs. While some new products are being hailed as exotic or innovative within the industry, others have been described as "toxic".
>
> I fear that the risk presented by some of these new products may not be fully understood by those who have invested in them.

Finally, Michael Osnato, the Chief of the Complex Financial Instruments Unit of the SEC's Division of Enforcement, discussed potential enforcement sanctions in the context of structured products. He indicated that the Division may bring additional cases relating to structured products along the lines of its 2015 action related to an FX-linked structured product. The SEC may bring actions relating to complex securities based on a "corporate negligence" theory — for example, where there are supervisory failures or other failures to communicate within an institution that is designing a complex product.

FINRA Proposes Amendments to Communication Rules – Rule 2273: Educational Communication Related to Recruitment Practices and Account Transfers

On December 23, 2015, FINRA filed a proposed amendment to its communication rules with the SEC, proposed Rule 2273.[2] The proposal incorporates comments and feedback received from FINRA's March 2014 proposal of Rule 2243, which sought to establish disclosure and reporting obligations with regard to member recruitment practices and account transfers. Rule 2243 proposed two reporting obligations: (1) a disclosure obligation applicable to the extent a firm attempts to induce a former customer of a representative to transfer the customer's assets to the new firm; and (2) a disclosure obligation to FINRA when a firm provides a significant increase in compensation for representatives transferring to the firm. In contrast, proposed Rule 2273 revises this approach by removing the second disclosure obligation and focusing its attention on providing customers with disclosures about the consequences of transferring their assets.

Background

Representatives who transfer between FINRA member firms often contact their former customers in an effort to induce them to transfer their assets to the representative's new firm.[3] FINRA is concerned that the former customer's prior experience with the representative could overshadow other important questions that should be considered before the customer agrees to transfer assets to the representative's new firm. (This concern, in part, arises because the representative may receive additional compensation from the new firm, which may present a conflict of interest.) Proposed Rule 2273 would require FINRA member firms to provide these former customers with an educational communication that highlights the key implications of transferring assets, such as:

- whether the representative is receiving a financial incentive and whether that creates a conflict of interest;
- the potential costs to the customer of leaving the current firm;
- the costs of transferring assets to the new firm, such as any differences in pricing structure and fees; and
- the differences in the products and services offered by the new firm compared to the customer's current firm.

The educational communication is intended to prompt the customer to make further inquiries and gather information in order to be able to make an informed decision before any transfer.

[2] The proposed rule may be found at the following link: http://www.finra.org/industry/rule-filings/sr-finra-2015-057?utm_source=MM&utm_medium=email&utm_campaign=Weekly%5FUpdate%5F010616%5FFINAL.
[3] We would imagine that some readers of this publication have received phone calls from time to time on this point.

Delivery Requirement

Under the proposed rule, the educational communication would be required from the member firm when: (1) the firm, directly or through a representative, individually contacts a former customer of that representative to induce the customer to transfer assets to the firm; or (2) absent individual contact, a former customer of a representative transfers assets to an account assigned to the present representative at the firm. The proposed rule defines "former customer" as any customer who had a securities account assigned to the representative at the representative's previous firm.[4] The types of communications that would trigger the delivery requirement would be broad and include both oral and written communications. Group communications such as mass mailings, e-mails and automated phone messages would also trigger the delivery requirement. This delivery requirement would apply for a period of three months following the date that the representative begins employment or associates with the new firm. After three months, contact with former customers would no longer trigger the educational-communication delivery requirement.

Timing and Means of Delivery

The proposed rule requires that the educational communication be delivered at the time of first individualized contact with a former customer. If such contact is written, the educational communication must accompany such writing. In the case of electronic contact, a hyperlink to the educational communication would be permitted. If the contact is oral, then the educational communication must be sent to the former customer within three business days of the oral contact or along with any other documentation sent to the former customer related to the transfer of assets, whichever is earlier. The former customer also must be notified orally that an educational communication with important considerations for deciding whether to transfer assets to the firm will be provided to him or her.

When there is no individualized contact and a former customer chooses to transfer his or her assets to the new firm, the proposed rule requires that the educational communication be delivered to the former customer with the transfer approval documentation.

Format of the Educational Requirement

The format of the educational communication will be a uniform, FINRA-created form; members will not be allowed to use any alternative formats. This FINRA-created form, which was submitted as Exhibit 3 of the rule proposal, is a two-page document titled "Issues to consider when your broker changes firm," and includes the following subsections:

- Could financial incentives create a conflict of interest for your broker?
- Can you transfer all your holdings to the new firm? What are the implications and costs if you can't?
- What costs will you pay—both in the short term and ongoing—if you change firms?
- How do the products at the new firm compare with your current firm?
- What level of service will you have?

The form also includes FINRA's logo, a brief description about FINRA and a hyperlink to FINRA's website.

Status

If the SEC approves the proposed rule, FINRA will announce the effective date of the rule no later than 60 days following SEC approval. The effective date of the proposed rule will be no later than 180 days following such SEC approval announcement. On February 4, 2016, the SEC review period was extended to March 29, 2016.

FINRA Warns Investors About High-Yield CD Offers

In January 2016, FINRA issued an investor alert (http://www.finra.org/investors/alerts/high-yield-cd-offers) warning broker-dealers regarding improper promotions of high-yielding CDs. In some cases, these promotions are not being used by these brokers to actually sell the CDs; instead, they are using the promotions to lure investors into purchasing a different, high-commission product, such as a fixed or equity-indexed annuity.

[4] However, institutional accounts (as defined in FINRA Rule 4512(c)) held by entities other than a natural person are excluded from this definition.

FINRA issued the alert based on calls made to its Securities Helpline for Seniors (1-844-57-HELPS (1-844-574-3577)).

In the alert, FINRA advises investors to be cautious about these types of offers. Investors who contact the broker about the high-yielding CD end up being invited to the broker's office to hear a sales pitch about a completely different product. The alert also describes different variations of this "bait-and-switch."

Needless to say, careful FINRA member firms monitor the sales activities of their personnel to prevent these types of activities.

Historical Underlying Asset Performance: Tables vs. Graphs

In our last issue, we discussed the historical performance period of underlying reference assets that should be included in structured note prospectuses. In this issue, in response to questions received from market participants, we discuss the format of these disclosures.

The Morgan Stanley Letter and Item 201 of Regulation S-K. The SEC's "Morgan Stanley" letter[5] requires a prospectus for a structured product referencing the performance of a stock to set forth historic trading information as to that stock. Specifically, the letter requires "[i]nformation concerning the market price of the [reference stock] similar to that called for by Item 201(a) of Regulation S-K."

In turn, Item 201(a) of Regulation S-K, which applies to prospectus and Exchange Act disclosures, requires, as to equity securities traded on an exchange (which is usually the case for structured notes), disclosure of "the high and low sales prices for the equity…as reported in the consolidated transaction reporting system or, if not so reported, as reported on the principal exchange market for such equity."

As a result, in order to include disclosure of the "high and low sales prices," many issuers, particularly in the early days of the structured note market, used a tabular format to set forth this information, much as might be included in the relevant issuer's annual report.

In recent years, an increasing number of issuers use a graph, setting forth, for example, only the closing prices for the relevant underlying stock. This disclosure might not, strictly speaking, comply with the Item 201(a) requirements that would apply to an annual report or prospectus. However, the Morgan Stanley letter uses the term "[i]nformation…*similar to* that called for by Item 201(a)." (Emphasis added.) This text has been viewed by many as permitting the presentation of this information as a single graph, especially since some individuals believe that this presentation is a more user-friendly way of informing investors as to the historic performance. The graphic presentation is also similar to the format in which many investors review historical performance information when they refer to publicly available resources, such as web-based finance portals. (As many readers of this publication know, some issuers provide both a graph and a table.)

(Note that Regulation S-T, which governs filings with the SEC using the EDGAR system, contains formatting rules, such as Rule 304, as to any graphs that are part of a filing.)

Application to ETFs, Commodities and Indices. ETF shares trade on a national securities exchange. Accordingly, whichever format they choose, issuers will typically use the same format for ETFs as they do for single stocks.

In contrast, commodities, futures contracts and indices (whether equity indices or securities indices) are not explicitly governed by the Morgan Stanley letter. Of course, the Morgan Stanley letter is viewed by many in the market as a useful framework for considering the disclosures as to these other types of underlying assets. Accordingly, some issuers will use a presentation for these indices comparable to that which they would for individual single stocks. However, practice is not uniform on this point.

[5] A copy of the letter may be found at the following link: http://media.mofo.com/files/Uploads/Images/Morgan-Stanley-6-24-1996.pdf.

Structured Products 2015
At A Glance

$44.1 billion

Total Notional of Structured Product Issuances in 2015.[1] $42.6 billion was issued in 2014.

8,567

Total Number of Structured Product Issuances in 2015. 9,232 Structured Products were issued in 2014.

$5.1 million

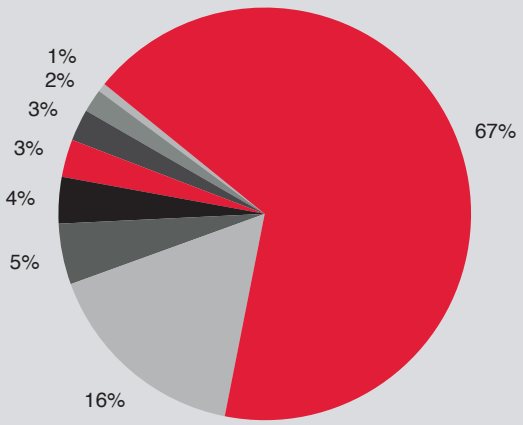
Average Size of Structured Product Transactions in 2015. The average in 2014 was $4.6 million.

What are Structured Products?

Structured products or market-linked investments are debt obligations with cash flow characteristics that depend on the performance of one or more reference assets. The prototypical structured product may be a senior note with a return based on a popular index, such as the S&P 500® Index or the Dow Jones Industrial Average℠. These products are designed by broker-dealers to meet the risk/reward needs of investors and offer distinct benefits that cannot typically be obtained from other types of investments.

2015 Issuance by Asset Class

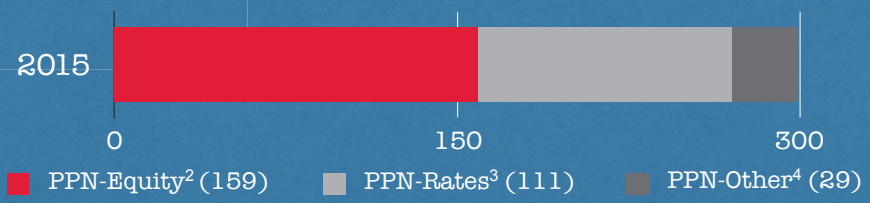
(in $ billions)



- Equity index.....$29.6
- Single stock.....$7.2
- ETF.....$2.1
- Basket of stocks.....$1.6
- Interest rate.....$1.3
- Multiple/Other.....$1.1
- Commodities.....$0.8
- Foreign exchange.....$0.3

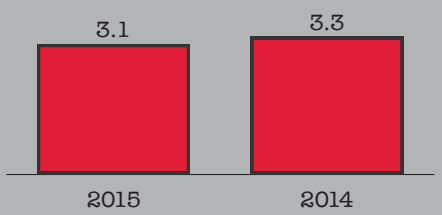
Principal Protected Notes (PPN)

4.2% of all structured notes issued in 2015 are designed to provide 100% of principal back at maturity.



Weighted Average Maturity

(in years)



MORRISON | FOERSTER

1 - Includes U.S. structured notes registered with the SEC in 2015. Excludes plain-vanilla, lightly structured notes such as "step ups", fixed-to-floating notes and capped floaters.
2 - Includes single-stocks, indexes, baskets and ETFs, all in the equity asset class.
3 - Notes based on CMS spreads and CMS rates.
4 - Includes mixed underlies (rates and equity) and commodity underliers.

For more information about structured products, please visit: www.mofo.com/special-content/structured-products

Source: ***Prospect News***

www.mofo.com

Upcoming Event

Current Practices and Issues for Foreign Broker-Dealers Under Rule 15a-6 in 2016

On Wednesday, March 30, 2016, Morrison & Foerster Senior Of Counsel Hillel T. Cohn will present on current practices and issues for foreign broker-dealers under Rule 15a-6. This session will cover topics including: Summary of Rule 15a-6 requirements; risks and responsibilities of acting as a chaperoning broker; practical issues in intermediating Rule 144A and other transactions; benefits of an intermediary agreement; and dealing with retail customers under Rule 15a-6.

For more information about this complementary CLE teleconference, or to register, click here.

Announcing our *Structured Thoughts* LinkedIn Group

Morrison & Foerster has created a LinkedIn group, *StructuredThoughts.* The group will serve as a central resource for all things Structured Thoughts. We have posted back issues of the newsletter and, from time to time, will be disseminating 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.

Contacts

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

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

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

Alexandra Perry
New York
(212) 336-4261
alexandraperry@mofo.com

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

Morrison & Foerster has been shortlisted for the 2016 Equity Derivatives Law Firm of the Year for the *EQDerivatives* Global Equity & Volatility Derivatives Awards. 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.

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 12 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.

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.