Volume 10, Issue 3 | June 26, 2019

STRUCTURED THOUGHTS

NEWS FOR THE FINANCIAL SERVICES COMMUNITY

IN THIS ISSUE

REGULATION BEST INTEREST AND STRUCTURED PRODUCTS

In June 2019, after considerable debate and discussion over the course of several years, the SEC adopted its new Regulation Best Interest ("BI")[1] which governs the standard of conduct that must be observed by broker-dealers that transact with retail customers. The SEC also approved its Form CRS Relationship Summary provisions.[2]

In this article, we focus on the impact of these regulatory actions on structured product offerings.

REGULATION BEST INTEREST

Regulation BI creates an enhanced standard of conduct for broker-dealers and their associated persons. It applies when they make any recommendation of a securities transaction or an investment strategy involving securities to a "retail customer." Notably, the SEC did not elect to impose a fiduciary standard of the type that is applicable to investment advisers. Instead, when making a recommendation that is covered by the

[1] This release may be found at the following link: https://www.sec.gov/rules/final/2019/34-86031.pdf Due to its length, you should exercise caution about printing it. That being said, the text of the release includes valuable insights into the SEC's views regarding the rule, and the considerations that were made when evaluating input from the (many) commentators on the proposal.

[2] This release may be found at the following link: https://www.sec.gov/rules/final/2019/34-86032.pdf Again, we recommend caution in printing it.

rule, a broker-dealer must act in the customer's "best interest," and may not put its own interests ahead of those of its customer.

The term "retail customer" is defined to include any individual investor acting for its own account – no matter what the sophistication or degree of wealth that the investor has. Of course, this is a broader definition than FINRA's historic definition, which excludes certain "ultra-high net worth" investors from its "retail investor" definition.[3]

In addition, the regulation does not define the term "best interest." A broker-dealer's compliance will depend upon an assessment of the facts and circumstances at the time a relevant recommendation is made. Similarly, the term "recommendation" is not defined in the regulation, and it is subject to the relevant circumstances.

The best interest standard consists of four components, described as follows:

- **The Disclosure Component** — the final rule requires full and fair written disclosure of all material facts relating to conflicts of interest associated with the recommendation. The term "conflict of interest" is defined as an interest that might incline a broker-dealer or an associated person, consciously or unconsciously, to make a recommendation that is not disinterested.

  In the structured products sector, these conflicts are frequently subject to substantial prospectus disclosures; for example, these conflicts include, but are not limited to, broker-dealer compensation in connection with the relevant offering, and hedging profits that the broker-dealer may earn from the related transactions. These factors may materially increase a representative's incentive to recommend a structured note to a retail investor.

- **The Care Component** — the broker-dealer must exercise reasonable diligence, care, skill and prudence to:

  - understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers[4];

  - have a reasonable basis to believe that the recommendation is in the best interest of the relevant retail customer to whom the recommendation is made, based on the retail customer's investment profile and the potential risks and rewards associated with the recommendation[5]; and

  - have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed individually, is not excessive and is in the retail customer's best interest when considered in light of the retail customer's investment profile regulation.[6]

    This prong of the rule contains an express requirement that broker-dealers consider the costs of a recommended transaction. However, in this regard, the SEC indicated that costs will not be the only relevant consideration, and the rule does not impose any requirement that broker-dealers recommend to their clients the least expensive product that is available. In its release, the SEC approvingly cited prior FINRA guidance, stating that when broker-dealers are recommending complex or costly products, including structured products, they should first consider whether less complex or costly products could achieve the same objectives for their retail customers.[7] For example, in some cases, a structured note could be replicated through an investment in several related instruments.

- **The Conflict of Interest Component** — the rule establishes an obligation for broker-dealers to establish written policies and procedures to comply with the regulation. Broker-dealers also must identify and, depending on the type of conflict, either disclose, mitigate or eliminate these conflicts of interest. Specifically, the rule requires broker-dealers to eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on sales of specific securities or types of securities within a specified period of time. These types of activities create high-pressure situations for associated persons, and jeopardize their ability to act in the best interest of retail customers. In these cases, the relevant conflicts of interest cannot be reasonably mitigated. In contrast, the rule does not eliminate the ability of broker-dealers to receive transaction-based compensation, such as a brokerage commission.

  This component requires broker-dealers to identify

[3] *See* FINRA Rule 4512(c).
[4] Readers will most likely associate this prong with FINRA's historic "reasonable suitability" standard.
[5] Readers will most likely associate this prong with FINRA's historic "customer-specific suitability" standard.
[6] This concept is currently included in FINRA Rule 2111.
[7] See FINRA Regulatory Notice 12-03.

and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with these types of limitations. For example, if a broker-dealer offered only proprietary products, and not those of third parties, retail customers would need to be made aware of these limitations.

- **The Compliance Component** — the regulation establishes a general compliance obligation that requires broker-dealers to establish policies and procedures to achieve compliance with Regulation BI.

FORM CRS

Under the SEC's new rules and related amendments, both investment advisers and broker-dealers will be required to provide a brief "relationship summary" disclosure to "retail investors."[8] This disclosure is known as Form CRS. This form uses a standardized Q&A format that designed to promote comparisons among firms by retail investors. The form requires the disclosure of summary information about a firm's services, fees, conflicts of interest, relevant legal standard of conduct, the disciplinary history of the firm and its financial professionals, and how investors may obtain additional information about the relevant firm. For each of broker-dealers and investment advisors, the length of the form is limited to two pages. Broker-dealers that specialize in structured products may be able to address issues relating to this product class in these documents. However, for full-service brokerage firms that have broader offerings, disclosures relating to individual product classes may not be discussed to a significant degree in these documents.

EFFECTIVE DATES

The SEC established the compliance date for both Regulation BI and Form CRS of June 30, 2019. At that time, broker-dealers that make the relevant recommendations must be in compliance with Regulation BI, and will need to file their updated Form CRS by that time.

A NOTE ABOUT STRUCTURED CERTIFICATES OF DEPOSIT

By its terms, Regulation BI applies to transactions in securities, as opposed to brokered bank deposits. In that sense, equity-linked certificates of deposit should be outside the scope of the regulation. That being said:

- it is possible under some circumstances for a "certificate of deposit" to be treated as a "security"[9];

- especially in the case of complex instruments of this type, which are often sold to many of the same investors to whom structured notes are offered, broker-dealers may wish to consider applying similar procedures to the sale of these instruments, in order to comply with relevant "best practices," and to avoid the possibility of confusion among their representatives or investors.

ACTION ITEMS

Needless to say, broker-dealers will be working over the next year to adapt their policies and procedures to reflect the new rules. Compensation structures, and how they related to different types of products, will need to be carefully evaluated in light of the new conflict of interest rules. To the extent not already done in light of recent regulatory actions, sales competitions for structured products and other securities are likely to have seen their last days.

Broker-dealers who sell structured products through third-party dealers will want to update their "know-your-dealer" questionnaires and procedures to reflect the new rules. For example, broker-dealers will seek to know what changes their distributors are making in order to comply with the rules, and to what extent their product offerings will be changed to reflect these changes.

SEC REQUESTS COMMENTS AS TO SECURITIES OFFERING EXEMPTIONS

In June 2019, the SEC requested public comment on ways to simplify, harmonize and improve the exemptions from registration under the Securities Act of 1933. In this concept release, the SEC identified a number of topics to be addressed, including:

- evaluating the overall framework and coverage of the existing exemptions from registration;

- adjusting the limitations on who should be permitted to invest in particular exempt offerings (and in what amounts), such as the Regulation D "accredited investor" criteria;

[8] Because Form CRS is provided before the commencement of a relationship, the definition is slightly different than it is in the case of Regulation BI.

[9] *See*, for example, the discussion in our article, "The Return of Gary Plastics," which may be found at the following link: https://media2.mofo.com/documents/180810-structured-thoughts.pdf

- facilitating the transition of an offering from one type of offering to another (such as when a Regulation D offering becomes a public offering, and the reverse); and

- updating secondary trading rules with respect to securities that were offered in an exempt offering.

The SEC's press release and fact sheet about the review may be found at the following link: https://www.sec.gov/news/press-release/2019-97 A public comment period will be open for 90 days.

Any developments in this area will be of interest to the structured products industry. For example, the use of non-registered platforms for structured note offerings can reduce the SEC filing requirements, and reduce other offering expenses. In addition, non-registered offerings are not, strictly speaking, subject to the limitations on underlying assets that are imposed by the so-called Morgan Stanley/Reading Room letter.[10] Additional flexibility for the use of non-registered offerings may broaden the use of these types of offerings in the future.

PRIIPS – NO SCOPE FOR CLARITY

In May 2019, the EU Commission responded to a letter from the Joint Committee of the European Supervisory Authorities (the "ESAs") dated July 19, 2018, in which the ESAs asked the Commission, as a matter of urgency, for detailed public guidance on which types of products come within the scope of the PRIIPs Regulation (1286/2014) (the "Regulation").

Unfortunately, in their response, the Commission provided the ESAs no joy, either on the matter of urgency or the need for clarity. Although it took almost a year to respond to the ESAs' letter, the response did not give any meaningful clarity as to the scope of the PRIIPs Regulation, and its contents were regarded as hugely disappointing by market participants.

CONCERNS RAISED BY THE ESAS

The Regulation applies, inter alia, to the sale or distribution to EU retail investors of investments "where…the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor."

This definition is extremely broad, and no official guidance has been published as to the kind of products that either do or do not fall within the scope of the Regulation.

Although the ESAs' letter concerns PRIIPs generally, it raises particular concerns in respect of the retail bond market. The ESAs highlight a significant reduction in the availability of corporate bonds to retail investors (of up to a 60% decline in some jurisdictions) in the first quarter of 2018, compared to the first quarter of 2017, which they believe is the result of uncertainty over the exact scope of the PRIIPs Regulation.

Some concerns have been raised by market participants that, on a strict reading of the definition of what constitutes a PRIIP under the PRIIPs Regulation, certain "vanilla" floating rate notes could come within its scope. Although, since the inception of the PRIIPs process, the EU authorities have indicated that the legislation should not apply to "vanilla" products, many manufacturers/distributors have taken a conservative approach, particularly in relation to floating rate notes with certain step-up and call features. This has resulted in many products ceasing to be made available to retail investors, in order to avoid the need to produce a Key Information Document, thereby reducing investor choice.

In their letter to the EU Commission, the ESAs state that they do not believe that it is appropriate for them to provide guidance on this matter, as the question of the scope of the regulation relates to the "Level 1" text of the Regulation. They do, however, provide their analysis to the EU Commission on which bonds with different types of features (perpetual, subordinated, fixed rate, variable rate, puttable, callable and convertible) fall within the scope of the Regulation and ask the Commission to confirm whether it agrees with the ESAs' analysis. The ESAs conclude that (absent additional features that would bring such bonds in-scope) perpetual, subordinated, fixed rate and puttable bonds should be out of the scope of the Regulation, but that convertible bonds are likely to be in-scope. The ESAs also conclude that whether variable rate or callable bonds are in-scope will depend upon the specific features of such bonds. For instance, the specification of a reference rate to determine the net present value of future bond payments, when calculating a make-whole amount on the exercise of a call, may render the bond a PRIIP where the reference rate fluctuates.

THE EU COMMISSION'S RESPONSE

In its reply, the EU Commission notes that only the European Court of Justice can provide binding interpretations on the PRIIPs Regulation. It expresses the view, however, that a bond made available to retail

[10] That being said, when non-registered offerings are used to offer securities to these types of assets, caution must be exercised regarding the appropriateness of the disclosures for the relevant offering documents, and the suitability of the instruments for the relevant investors.

investors will come within the scope of the PRIIPs Regulation solely in the case where potential or compulsory payments (whether of interest or principal) may vary due to its exposure to reference values or to the performance of one or more assets that are not directly purchased by the retail investors.

The Commission states that the analysis needs to be made on a case-by-case basis for each bond considering all of such bond's features, regardless of its type or name. It therefore states that it is necessary to assess whether the terms and conditions of the bond provide for different payments depending on a variety of pay-out events such that the actual amount to be repaid is not certain at the outset of the contract.

The Commission therefore states that it is neither feasible nor prudent to agree in abstract terms whether certain categories of bonds would be regarded as inside or outside the scope of the Regulation.

IMPLICATIONS OF RESPONSE

The EU Commission's response will be regarded as deeply disappointing by market participants, and it is hard to see how it will assuage the concerns of any potential issuers who were previously reluctant to issue bonds to retail investors without clarity concerning whether such bonds would be regarded as coming within the scope of the PRIIPs Regulation. Its description of when it considers that bonds will come within the scope of the Regulation adds little, if anything, to previous statements and guidance.

Potential issuers are therefore likely to continue to take a very cautious approach in whether a bond intended for retail investors comes within the scope of the PRIIPs Regulation. It is also likely that trend of declining liquidity in both the primary and secondary markets for bonds sold to retail investors, as identified by the ESAs in their letter to the EU Commission, is likely to continue without any further clarity on the horizon.

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