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Structured Thoughts

News for the financial services community.

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FINRA Releases 2015 Regulatory and Exam Priorities Letter: Structured Products Remain an Area of Focus

On January 6, 2015, FINRA issued its annual regulatory and examination priorities letter. (http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p602239.pdf).

As in the past few years, structured products will remain an area of FINRA focus in 2015. Many of the points raised by the letter are consistent with FINRA's prior guidance to broker-dealers. The letter points out that issues related to product and service offerings generally include "product complexity, opacity in the market for a product or its underlying components, insufficient or generic disclosure, enticing teaser rate fee structures and insufficient training for salespersons to understand the products." FINRA requests firms to "continue to conduct rigorous new product reviews, assess reasonable-basis and customer-specific suitability prior to offerings and permit wealth management to make independent decisions about the products and services that are best for their customers."

In particular, the letter indicates that FINRA will continue focusing on structured products "with complex payout structures and using proprietary indices as reference assets." The letter states that "complex features, long maturities, and linkages to less-traditional or less well-understood reference assets in some structured retail products may present investors with unique or unfamiliar risks." FINRA points out that some products that were previously available only to sophisticated investors are now offered to retail investors. Because retail investors may not understand the complexities of structured products, retail communications are important and FINRA reminds firms to comply with the communication rules.

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In addition, because distributors have an incentive to increase their distribution of structured products, potentially through distributors that may not have adequate controls, FINRA requested wholesalers to "have robust Know-Your-Distributor policies and procedures reasonably designed to ensure potential distributors have adequate controls and systems in place." FINRA examiners will focus on additional conflicts issues when the distributor and the wholesaler are affiliates.

The letter also references a number of additional focus areas that often involve structured products, including:

- Suitability (including suitability in light of changing circumstances, such as a fall in oil prices, or investments linked to emerging and frontier market indices);
- Conflicts of interest;
- Risk disclosures;
- Interest rate-sensitive fixed income securities;
- Exchange-traded products tracking alternatively weighted indices, which may be unduly complex for some investors;
- Timely filing with FINRA of relevant FWPs, including FWPs relating to registered structured notes (when required under the FINRA rules);
- Due diligence and suitability of private placements; and
- Sales to elderly investors of products that are not suitable for them.

In connection with its fair pricing reviews, the letter notes that FINRA is "looking for instances in which firms that are intermediating transactions in structured products may not have disclosed information to their customers about how they would charge the customer." FINRA advises in the letter that dealers "that position a trade for the purpose of taking a spread when their customer has agreed to pay the dealer an explicit fee for the transaction, should look closely at whether they are meeting the customer's expectations about how the dealer should execute the trade and be compensated."

For additional discussion of the annual letter, please see our client alert, "FINRA Issues a Packed Priorities Letter for 2015": http://www.mofo.com/~/media/Files/ClientAlert/2015/01/150108FINRAPrioritiesLetter.pdf.

OCIE Exam Priorities: 2015

In January 2015, the National Exam Program of the SEC's Office of Compliance Inspections and Examinations (the "OCIE") published its examination priorities for 2015. Our client alert describing the OCIE's statements may be found at the following link: http://www.mofo.com/~/media/Files/ClientAlert/2015/01/150114OCIEPublishesExamPriorities.pdf.

The OCIE described three key areas of focus, including sales to retail investors, market-wide risks and using data analytics to identify improper activities.

Among other things, in connection with its discussion of retail investors and investors saving for retirement, the OCIE indicates that it will "evaluate registered entities' recommendations or determinations to invest retirement assets into complex or structured products and higher yield securities, including whether the due diligence conducted, the disclosures made, and the suitability of the recommendations or determinations are consistent with existing legal requirements."

The full text of the OCIE's statements may be found at the following link: http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf.

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In Re: TVIX Securities Litigation—Second Circuit Affirms Lower Court Decision

In December 2014, the U.S. Court of Appeals for the Second Circuit affirmed[1] the district court's decision[2] (our recent article regarding the district court's decision can be found here) that Credit Suisse AG is not liable for the alleged losses arising from disclosures in the offering documents for its exchange traded notes ("ETNs").[3] The notes at issue in the suit offered leveraged exposure to the S&P VIX Short-Term Futures Index. The value of this issuance decreased significantly in 2012, when the issuer temporarily suspended the issuance of new ETNs.

Regarding the information contained in the pricing supplement, the three-judge panel wrote that it was highly unlikely that the bank's disclosures could have been misunderstood by a reasonable investor. The Second Circuit found that investors should have realized that Credit Suisse intended the notes to be short-term investments.

The panel explained, "The pricing supplement clearly disclosed in numerous, repeated, sometimes boldfaced warnings that the ETNs were short-term trading vehicles designed to achieve their stated investment objectives only on a daily basis and that the investment's value was likely to erode if held for longer periods."[4] The panel went on to say that "the hypothetical examples—prefaced by extensive disclaimers … did not suggest that [the notes] were an appropriate long-term investment," and "the Pricing Supplement and Press Release explained Credit Suisse's complete discretion over the issuance or nonissuance of new ETNs … no reasonable investor could have read these materials without realizing the risk inherent in purchasing TVIX ETNs."

ESMA's MiFID II Technical Advice and Consultation Paper

Following MiFID II coming into force in July 2014[5], the focus is now on the significant amount of delegated legislation and technical standards that need to be put in place prior to the MiFID II provisions becoming effective in the EU in January 2017. Many of these technical standards are to be drafted by the European Securities and Markets Authority (ESMA).

ESMA published an initial Consultation Paper and a Discussion Paper in May 2014 setting out its initial views on a number of issues. It followed-up on these papers on 19 December 2014 by publishing its final technical advice to the EU Commission[6] and a second Consultation Paper[7] (which contains a number of draft regulatory technical standards (RTS) and implementing technical standards (ITS)).

A few areas of note from the Consultation Paper and technical advice are set out below:

Product Governance

Under MiFID II, ESMA is to provide technical advice on detailed product governance arrangements for investment firms manufacturing and distributing financial instruments and structured deposits. Having considered the responses from its earlier consultation, ESMA states that the technical advice now clarifies that, for the purpose of the product governance requirements, investment firms that create, develop, issue and/or design investment products should be considered as

[1] The decision was issued in a summary order, and is not intended by the court to have precedential effect
[2] *In Re: TVIX Securities Litigation*, No. 14-2241 (2d Cir. Dec. 16, 2014).
[3] *Id.*
[4] *See supra* note 1.
[5] MiFID II comprises Regulation (EU) No 600/2014, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN and recast Directive 2014/65/EU, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN
[6] http://www.esma.europa.eu/system/files/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf
[7] http://www.esma.europa.eu/system/files/2014-1570_cp_mifid_ii.pdf

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"manufacturers" for the purpose of the rules. ESMA states that the product governance rules should apply in a way that is appropriate and proportionate taking into account the nature of the investment product, the investment service and the target market.

In the technical advice, ESMA sets out separate product governance obligations for manufacturers and distributors. Manufacturer requirements include:

- the firm must maintain procedures and measures to ensure that the design of the product complies with the requirements as to the proper management of conflicts of interest;
- the firm's compliance function must oversee the development and periodic review of product governance arrangements in order to detect any risk of failure by manufacturers to comply with their obligations;
- when manufacturing products, a firm must identify the potential target market for each product and be able to specify the type(s) of client for whose needs, characteristics and objectives the product is compatible;
- the target market must be identified at a sufficiently granular level to ensure the exclusion of investors for whose needs, characteristics and objectives the product is not compatible; and
- firms must consider the charging structure proposed for their products, including checking that costs and other charges are compatible with the needs, objectives and characteristics of the target market and do not undermine the return expectations of the product.

Requirements for distributors include:

- when deciding the range of investment products that will be offered, firms must have in place adequate product governance arrangements to ensure that products and services to be offered are compatible with the needs, characteristics and objectives of an identified target market and that the distribution strategy is consistent with such target market;
- when deciding the range of investment products and services to be offered and the target markets, firms must maintain procedures and measures to ensure compliance with all applicable MiFID II requirements, including those relating to disclosure, suitability, appropriateness, inducements and conflicts of interest;
- firms must review the investment products they distribute and the services they provide on a regular basis taking into account any event that could materially affect the potential risk to the identified target market and assessing whether the product or service remains consistent with the needs of such target market; and
- the management body must have effective control over the firm's product governance process to determine the range of investment products to be distributed and the needs, characteristics and objectives of the identified target market.

Complex Products and Suitability/Appropriateness Assessments

ESMA is required to provide technical advice on certain aspects of requirements under MiFID II that firms make suitability or appropriateness assessments of their clients in respect of the provision of relevant financial services and activities, including provisions relating to complex and non-complex financial instruments. This is particularly relevant in relation to the application of the "execution-only" exemption under MiFID II where firms providing certain non-advised services or activities do not have to make any assessment as to suitability or appropriateness. This exemption is only available in respect of the instruments specified in Article 25(4) of the MiFID II Directive.

In addition to specifying specific instruments that benefit from the exemption, Article 25(4) contains a general category of "other non-complex financial instruments". ESMA notes that Article 25(4) specifically excludes certain instruments from the list of products that can benefit from the execution-only exemption, including (i) shares embedding derivatives, (ii) structured UCITS and (iii) bonds or securitised debt embedding a derivative or incorporating a structure which makes it

difficult for the client to understand the risk involved. ESMA states that such instruments should be excluded from provisions in delegated legislation specifying which instruments should come within the meaning of “other non-complex financial instruments” (currently contained in Article 38 of the existing MiFID implementing directive). ESMA’s position is consistent with the view of its predecessor (the Committee of European Securities Regulators (CESR)) that an instrument expressly excluded under Article 25(4) should not be brought back in under Article 38.

ESMA recommends adding two additional criteria to the current Article 38 criteria as to the requirements to be satisfied before an instrument can be non-complex:

- there is no clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay-out profile (e.g., a right to convert the instrument into a different investment); and
- there are no explicit or implicit exit charges that have the effect of making the investment illiquid.

In relation to the concept of a “structure which makes it difficult for the client to understand the risk involved”, ESMA notes that it is required to produce guidelines on this issue and that it is taking this work forward.

Transparency for Bonds, Structured Finance Instruments and Derivatives

In the Consultation Paper, ESMA undertakes detailed consideration of what constitutes a liquid market for the purpose of MiFID II Regulation. This is relevant in the context of the new pre-trade transparency requirements for bonds, structured finance instruments and bonds where competent authorities are permitted to grant waivers from such requirements in certain circumstances, including in relation to financial instruments for which there is not a liquid market. As required by MiFID II, ESMA focuses on average frequency and size of transactions, number and type of market participants, and average size of spreads. It proposes determining liquidity by dividing each asset group into more granular classes that share largely homogeneous liquidity characteristics and then sub-dividing such classes further by factors such as maturity, issue sub-type and issue size (for bonds) and derivative type, number of instruments, number of trades and total notional amount (for derivatives). Its conclusions for each sub-class are set out in detailed tables in the Consultation Paper.

Exchange Trading of Derivatives

In relation to determining whether a derivative is sufficiently liquid to be subject to the exchange trading requirement, ESMA considers similar factors as in relation to the transparency requirement and indicates in many cases that the thresholds will be the same or very similar as in relation to the test for the transparency rules, but this will not necessarily always be the case.

Next Steps

Considering that the Consultation Paper and technical advice run to well over a thousand pages in aggregate, the consultation period is short and concludes on 2 March 2015. A public hearing is set for 19 February 2015 in Paris. Following the end of the consultation, ESMA will seek to commence the process of finalising its draft RTS and ITS for submission to the EU Commission with it expected to submit the bulk of the RTS to the EU Commission by the end of 2015.

OCC Updates Retail Non-Deposit Investment Product Guidance in Comptroller’s Handbook

On January 14, 2015, the Office of the Comptroller of the Currency (OCC) updated the booklet in its Comptroller’s Handbook related to Retail Non-Deposit Investment Products (RNDIPs). The updated booklet replaced material originally issued in 1994 and provides helpful guidance to banks offering RNDIPs to retail customers. Structured products, because they are not entirely FDIC-insured, are considered RNDIPs.

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The purpose of the updated booklet is to provide clarifications in light of current business practices and to incorporate significant regulatory changes adopted under laws such as the Dodd-Frank Act of 2010.

The updated guidance cautions issuers to pay special attention to the accuracy, transparency, and meaningfulness of the disclosures regarding products that are more complex. The booklet cautions that, because sales practices involving complex securities inherently involve higher risk, heightened supervision is essential for customer protection. The issuance of structured products is repeatedly mentioned as an instance in which additional disclosures are required.

In the section entitled "Risk Management of RNDIP Sales Programs," the booklet discusses disclosure requirements for structured CDs. The section explains that structured CDs are covered by FDIC insurance up to the current depositor coverage limits, but the coverage does not extend to potential returns. Furthermore, FDIC insurance does not cover possible loss of principal when a client redeems or liquidates the structured CD before maturity. The OCC recommends that issuers use disclosure that accurately reflects these nuances. Readers of this publication are probably aware that most current disclosure documents for structured certificates of deposit describe these issues in fair detail, typically including appropriate risk factors.

The booklet also provides updated guidance for bank examiners, including sample information requests and internal control questionnaires. In regard to structured products, the internal control questionnaire asks if a bank's compliance reports list sales of products the bank considers more volatile, as well as the frequency of early redemption. Another question asks if the bank requires the broker-dealer to provide sufficient information to facilitate the bank's oversight of sales practices.

The updated booklet is useful for institutions that recommend and sell RNDIPs to retail customers. Banks can benefit from the detailed explanations of the types of information requests they may receive from OCC examiners. The new guidance provides banks with a framework for risk management that can be integral when preparing for an examination.

TLAC and Structured Notes

Financial institution issuers of structured products probably are all too aware of the heightened regulatory capital requirements and new quantitative liquidity measures that form part of the Basel III framework. To some extent, the liquidity measures, such as the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), will affect a financial institution's funding plans, including an issuer's interest in issuing shorter term or callable instruments. The newest proposed requirements may have a more direct impact on structured products.

In November 2014, the Financial Stability Board (FSB) launched a consultation on the adequacy of the loss-absorbing capacity of global systemically important banks (G-SIBs) in resolution. Banks in both Europe and the United States are subject to certain minimum regulatory capital requirements, as well as certain capital buffers, and, for the largest banks, a capital "surcharge." Despite these requirements, the FSB consultation discusses an internationally-agreed standard regarding the appropriate level and the form of total loss absorbing capacity for G-SIBs necessary to ensure orderly liquidations without the need for taxpayer injections of capital in a crisis scenario.

In brief, the FSB's proposed approach is to require that G-SIBs maintain a minimum level of capital that can absorb losses on both a going concern and a gone concern basis, which includes the capital that is held to satisfy the Basel III minimum capital requirements, but excludes capital held as part of the Basel III capital buffers, such as the capital conservation buffer (and the G-SIB extension of this buffer) as well as the counter-cyclical capital buffer. A G-SIB may be required to maintain a minimum TLAC of 16-20% of risk-weighted assets and a minimum leverage ratio of 6%. The FSB consultation also discusses the entities within a financial institution group that must hold TLAC and the types of eligible instruments. Generally, Tier 1 and Tier 2 capital instruments are "eligible." In order to satisfy the requirements, other debt securities must, among other things: be unsecured; have a minimum remaining maturity of at least one year; and be subordinated to excluded liabilities on the balance sheet of the resolution entity within the financial institution group. Certain types of liabilities are excluded, such as liabilities arising from derivatives or debt instruments with derivative-linked features like structured notes. The FSB's proposed exclusion from TLAC of structured notes and other securitized derivatives has

proven controversial, especially for those containing a prescribed level of principal protection, and European banks would have been expecting to be able to count such liabilities towards their minimum loss-absorbing liabilities requirements under the European resolution scheme, the Bank Recovery and Resolution Directive, or BRRD. Given that such securities can, in principle, be bailed-in in a resolution, it seems difficult to justify not being allowed to count them as bail-inable for the purpose of calculating TLAC. The consultation period on the FSB proposal closes on February 2, 2015. As a result of the comments on the proposal, the final formulation of the TLAC requirement may differ, perhaps significantly from the requirements describe in the FSB consultation. For example, many commenters have argued that at least a subset of structured notes (those that are principal protected) should "count" for TLAC purposes. For more information on the TLAC proposal, see our alert: http://www.mofo.com/~/media/Files/ClientAlert/2014/12/141205SafetoFail.pdf.

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

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

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

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

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