Structured Thoughts

News for the financial services community.

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FINRA's Proposed Amendments to the Corporate Financing Rules – Impact on Structured Notes

In April 2017, FINRA released a set of significant proposed amendments to its Rule 5110, known as the "Corporate Financing Rule." FINRA's regulatory notice relating to the proposed amendments, together with the text of the proposed revisions, may be found here.

The proposed revisions would make substantive, organizational and terminology changes to the rule. According to FINRA, the proposal is intended to modernize the rule, and to simplify and clarify its provisions.

In this article, we discuss the potential impact of the proposed revisions to the rule on offerings of structured notes. For additional discussion of the proposal, please see our client alert, which may be found here.

Underwriting Compensation and Hedging Activities

The proposal includes an effort to consolidate the existing provisions of the rule into a single definition of "underwriting compensation" to mean "any payment, right, interest, or benefit received or to be received by a participating member from any source for underwriting, allocation, distribution, advisory and other investment banking services in connection with a public offering."

In many structured note offerings, the underwriter or its affiliate will enter into a hedging transaction with the issuer. Accordingly, these arrangements raise the question of whether that hedge transaction could be deemed "underwriting compensation," requiring disclosure of the transaction's value.

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The proposed rules take a similar approach to the existing rules. New "Supplementary Material" would provide, in part: "derivative instruments acquired in a transaction related to the public offering and at a *fair price*, will be considered underwriting compensation but will have *no compensation value*." (Emphasis added.) In contrast, "derivative instruments acquired in a transaction related to the public offering but *not at a fair price*, will be considered underwriting compensation and subject to the normal valuation requirements of this Rule and members must provide a description of the methodology used to value the [derivative instrument]." (Emphasis added.)

The proposal indicates that a derivative will be considered to have been entered into at "fair value" when "participating members have priced a derivative instrument or non-convertible or non-exchangeable debt security in good faith, on an arm's-length, commercially reasonable basis, and in accordance with pricing methods and models and procedures used in the ordinary course of their business for pricing similar transactions."

Similar to the existing rule, the proposal appears to contemplate hedging arrangements between issuers and their affiliated underwriters, provided that the terms of the transaction satisfy the specified criteria.

The proposed new rules would purport to bar an underwriter from receiving underwriting compensation "for which a value cannot be determined." Of course, a party to a hedge transaction will likely not know the amount of profit or loss that may result from the transaction. However, that fact would not appear to bar entry into the hedge, as long as the transaction itself, like most financial transactions, can be valued.

Disclosure Requirements

The SEC regulation governing prospectus disclosures, Regulation S-K (Item 508), incorporates by reference FINRA's rules, and requires disclosure in the "Plan of Distribution" section of all items considered to be underwriting compensation. The proposed amendments attempt to provide guidance to issuers as to how to satisfy this disclosure obligation.

Under the proposed amendments, the specific value of each item of compensation need not be separately disclosed in the "Plan of Distribution" section. Instead, the proposed rules would provide that this section of the prospectus must simply describe the maximum aggregate amount of all underwriting compensation. As a result, the rule would clarify that, for example, if an underwriter receives an "underwriting discount" and a "structuring fee" (and/or other compensation, such as a license fee) for its services, these items would not need to be separately quantified in the Plan of Distribution section. However, to the extent that the underwriters receive compensation that is additional to the underwriting discount, the underwriting table on the prospectus cover page would need to include a footnote that cross-references the "Plan of Distribution" section in which the additional compensation is described.

Filing Requirements

Most structured notes are offered by financial institutions that have outstanding investment grade debt securities that rank equally with the structured notes. Accordingly, few offerings relating to structured notes are filed with FINRA given the availability of the exemption from FINRA filing that applies to these investment grade debt issuers. As a result, we will not address here the proposed changes to FINRA's filing requirements, such as its lengthening of the period in which offering documents must be filed. However, where offerings are required to be filed, if the underwriter or an affiliate enters into a derivative transaction relating to the public offering, the instrument will be subject to the filing requirement, and must be accompanied by a representation that a registered principal or senior manager of the participating member has determined if the transaction was or will be entered into at a fair price.

Exempted Offerings

The proposed amendment makes explicit that Rule 144A and Regulation S offerings of securities are exempt from the Corporate Financing Rule. This has become understood in the market, but was not explicitly stated in the text of the existing rule. Regulation D Rule 506 offerings were specifically exempt from the rule, and that would continue to be the case under the proposal.

Comment Period

FINRA has established a comment period ending May 30, 2017 for interested persons to submit comments.

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Massachusetts Secretary of State Challenges Sales of Structured CDs and Other Complex Products

A March 2017 consent order between the Massachusetts Securities Division and a broker-dealer serves as a useful reminder of sales practices that are best avoided in sales of complex instruments, whether in Massachusetts or any other state. The order focuses in particular on how improper incentives provided to registered representatives can lead to improper or unsuitable sales.

The Broker and Its Products

In the case at issue, a broker based in another state had partnered with local community banks, including several in the state of Massachusetts, to offer bank customers a variety of investment products. The broker occupied space within these community banks to offer products, and would share a portion of its revenues with the relevant banks. Among the products offered were market-linked certificates of deposit, non-traded REITs, non-traded business development companies and variable annuities. All of these products have been scrutinized in the past by FINRA and other regulators due to their potential complexity or potential risks.

Supervisory Procedures and Incentive Sales

The broker maintained supervisory procedures that limited its ability to award sales for particular financial products, that would serve as a "luxury" for the relevant persons or that would reward their spouses or other family members. Under the supervisory procedures, trips and other similar activities were chiefly designed to consist of training for the relevant representatives. Trips and similar activities required approval from the chief compliance officer. The procedures, citing relevant FINRA notices, also stated that the broker would not engage in sales contests that favored any one particular product or type of product over others.

However, in reality, the broker did, in fact, award vacations as a prize to its top ranking financial consultants. The broker also awarded accommodations to a guest of winners at its training sessions in the Caribbean. An official of the broker-dealer suggested to regional directors that they should use an upcoming contest to motivate sales. The broker also awarded baseball tickets, together with dinner and drinks, as a tool to spur additional sales. These prize programs were approved by executive officers of the broker. Needless to say, the consent order suggests that these prizes were believed to have incentivized representatives to sell the relevant products.

Sales to Vulnerable Investors

Financial representatives that received prizes under these programs made sales of a variety of complex instruments, including market-linked certificates of deposit, to elderly investors. In one case, the market-linked CD was purchased with the proceeds of a traditional non-market-linked CD. The Massachusetts secretary of state alleged that an elderly investor did not understand all of the risks of the market-linked CD, including that it would need to be held to maturity to guarantee a return of principal.

Violation of Law and Takeaways

As a result of these circumstances, the state of Massachusetts alleged that the broker did not properly supervise its representatives.

The case is a reminder that written supervisory procedures are only truly useful if followed. Sales incentives can compromise the judgment of registered representatives, and result in inappropriate recommendations. Broker-dealer compliance professionals are encouraged to exercise caution when approving them, and to consider whether and how they might steer investors to unsuitable investments.

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FINRA Observes Second Anniversary of Its Senior Helpline

On April 21, 2017, FINRA issued a press release marking the second anniversary of its Securities Helpline for Seniors. The press release may be found here.

As most of our readers know, the Helpline provides a toll-free number that senior individuals and their caretakers can call to voice concerns about the handling of their brokerage and investment accounts. The Helpline has not only been a useful resource for these individuals, but it has also helped FINRA understand the types of issues that these investors face.

The release notes a number of interesting statistics relating to the use of the Helpline in its two-year history:

Total calls to the Helpline:	9,200
Number of states from which calls were placed:	50
Average age of callers:	70
Number of matters referred to federal, state and non-U.S. regulators:	65
Referrals to adult protective services:	130
Voluntary reimbursements to callers generated through the Helpline:	$4.3 million

FINRA notes that the calls raised concerns about, among other issues, potential unsuitable recommendations, account churning, fraud and illegal activity involving brokerage accounts and investments.

FINRA also notes, approvingly, that many FINRA member firms have established designated points of contact to work with Helpline staff to streamline the resolution of investor issues.

In the release, FINRA also reported that in one case a senior investor called regarding an investment in a structured CD. The investor stated that the terms of the CD were not consistent with what he understood at the time of the purchase, and he indicated that, prior to the investment, he received 1% per year on a (conventional) savings account. At the time of purchase, and his move away from the conventional account, he was told the CD would pay 2.5 to 3.5% per year; however, when he received the confirmation of his purchase, he noticed that the return would be spread over the six-year term of the product. After speaking to FINRA's Helpline staff, the relevant broker-dealer agreed to sell the CD for the investor and to reimburse the customer for any loss incurred on the sale. This fact pattern reminds us that even relatively simple structured products, such as "lightly structured" CDs, have the potential to be mis-sold, and the sales of such products often require substantial supervision and training.

FINRA Revises Its Sanction Guidelines

In April 2017, FINRA announced that it had revised its sanction guidelines for violations of its rules. The new revisions, among other things:

- contain a new factor requiring that the exercise of undue influence over a customer, such as an elderly investor, be considered when adjudicating violations;
- introduce three new sanction guidelines: "Systemic Supervisory Failures," "Short Interest Reporting," and "Borrowing From or Lending to Customers";

- create a new factor related to the mitigating effect of regulator or firm-imposed sanctions and corrective actions that have been taken; and
- amend a number of sections of the sanction guidelines to revise sanctions for more serious FINRA rule.

The revised sanction guidelines became effective immediately, and may be found on FINRA's website here.

By way of explanation, the sanction guidelines do not stipulate fixed punishments or penalties for violations of the FINRA rules. Instead, the premise of the sanction guidelines is that FINRA adjudicators have a range of potential sanctions for a particular violation, and they may consider aggravating and mitigating factors in order to arrive at an appropriate sanction for the relevant violation.

The new revisions are the result of FINRA's most recent review of the sanction guidelines. FINRA has indicated that additional review is currently in process as to potential additional changes.

Our Take and a Few Additional Points

The new guidelines address a number of issues that have recently been of significant interest to U.S. regulators. For example, consistent with recent regulatory attention, FINRA has introduced a new principal consideration that examines whether a broker-dealer's employee has exercised undue influence over a customer. This new consideration reaffirms the notion that financial exploitation of senior and other vulnerable customers should result in more severe sanctions. This focus on vulnerable investors is consistent with the concerns behind FINRA's recent rule changes relating to senior investors, which we discussed here.

As to short interest reporting, under the prior guidelines, violations involving short interest reporting would have been determined under the guideline related to short sale However, FINRA believed that this method of review did not account for the different factors typically presented by short interest reporting violations. Accordingly, the introduction of the guideline for short interest reporting sets forth considerations that relate specifically to these cases.

FINRA also implemented changes relating to rule violations that involve churning or unauthorized transactions. The low end of the suspension range for an individual respondent who engages in churning or unauthorized transactions increased from 10 business days to one month. The high end of the suspension range for churning and unauthorized transactions for an individual respondent has increased from one year to two years; in addition, the revised guidelines for churning or unauthorized transactions recommend that FINRA adjudicators strongly consider imposing a bar from the industry on an individual respondent when the respondent acted recklessly or intentionally. This change reflects FINRA's 2017 exam priorities letter and its emphasis on excessive trading.

Upcoming Events

A "How to Guide" to Basic Derivatives, Swaps Clearing & Structured Products
New York City Bar
Wednesday, May 3, 2017
Morrison & Foerster Speaking Engagement, 9:00 a.m. – 1:00 p.m. EDT

New York City Bar
42 West 44th Street
New York, NY 10036

This course will enable both in-house and outside counsel to expand their skills and be more valuable to their clients by covering the why, what, when, where and how of derivatives. Partner Anna Pinedo will speak on a panel entitled "Key Considerations in Derivatives and Structured Products and Collateral."

Topics will include: Regulatory margin requirements; collateral posting and protection issues; bankruptcy and credit downgrade considerations; understanding netting of exposures, risk exposure, valuation and risk: notional values,

counterparty risk, pricing and leverage; use of derivatives in M&A; and tax implications of various derivatives and structured notes.

For more information, or to register, please click here.

Unit Investment Trusts and Structured UITs
Thursday, May 4, 2017
Paul Koo and Oscar Loynaz, Alaia Capital & Bradley Berman and Anna Pinedo, Morrison & Foerster LLP
8:30 a.m. – 9:30 a.m. EDT

Morrison & Foerster LLP
250 West 55th Street
New York, NY 10019

A unit investment trust, or UIT, is a type of registered investment company under the Investment Company Act of 1940, in which a portfolio of stocks, bonds or other securities are professionally selected and deposited into the trust. The portfolio is fixed and unmanaged. A UIT can offer investors diversification, liquidity and access to specific investment strategies. A UIT also may offer investors access to more structured returns that, in certain respects, may resemble the returns often associated with market-linked or structured products.

During the session, the speakers will discuss: Basic organizational structure and participants; regulation of UITs; filing and other requirements applicable to UITs; Structured UITs; benefits associated with Structured UITs; UITs and the DOL's fiduciary duty rule; and fiduciary and advisory issues generally.

For more information, or to register, please click here.

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, will disseminate news updates through the group.

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

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Morrison & Foerster is currently nominated for Americas Law Firm of the Year – Overall; US Law Firm of the Year – Transactions and US Law Firm of the Year – Regulatory for *GlobalCapital's* 2017 Americas Derivatives Awards. We were named Americas Law Firm of the Year in 2015 and 2016 by *GlobalCapital* for its Americas Derivatives Awards.

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

About Morrison & Foerster

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