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Structured Thoughts

News for the financial services community.

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Identifying Conflicts of Interest in Structured Products Offerings

With FINRA and other regulators focused on conflicts of interest in the broker-dealer industry, market participants are working diligently to identify and disclose, and where possible, mitigate, potential or actual conflicts of interest. In this article, we summarize the types of conflicts of interest that may present themselves. We encourage broker-dealers to consider these relationships and arrangements, and any others that might apply, in connection with their offerings of structured products and the formulation of conflicts of interest policies.

As we discuss in more detail below, some conflicts of interest are inherent given the nature of the product and the distribution channel. Other conflicts may arise due to the specific nature of the transaction.

Roles in Structured Product Offerings

In connection with an offering, the broker-dealer or its affiliates are likely to play several roles. Of course, this may involve the broker-dealer acting as underwriter for the securities of a parent or affiliated corporation. (As a result, many structured products offerings are subject to FINRA's specific rules relating to offerings involving conflicts of interest.) In addition, the broker-dealer may play additional roles, such as serving as calculation agent. In that role, it will calculate the payments due to holders of the product, and potentially make significant determinations upon the occurrence of a market disruption event, merger of a reference stock or index constituent, discontinuance of an index, or similar extraordinary event.

The underwriter or its affiliate is frequently the issuer's hedge counterparty. As a result of this arrangement, the hedge counterparty will have a significant role in structuring the transaction terms. The hedge counterparty will typically price the hedging arrangements with a view to making a profit; if successful, the hedge counterparty will typically receive such a profit regardless of whether the investors in the related structured note have achieved a positive or a negative return.

In connection with offerings referencing a proprietary index, the broker-dealer or its affiliate may be the sponsor of the index, or may be the "index calculation agent," determining the levels of the relevant index. Broker-dealers involved in

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such a manner will typically "wall off" the individuals or teams responsible for the index from the team responsible for structuring and selling the related structured note.

After the issuance of the product, the broker-dealer is likely to play a continuing role. It is likely to be a market-maker (perhaps the only market-maker) in the relevant structured product, as well as other securities of an affiliated issuer.

Compensation

In rendering the services described in the prior section, the broker-dealer expects to receive a variety of potential fees. And this is where the "rubber hits the road" in terms of addressing whether the conflict has been addressed appropriately, and whether compensation is reasonable.

In acting as underwriter for the product, the broker-dealer will receive an underwriting commission or similar compensation. A portion of these fees, or potentially an additional fee, may be paid as a structuring fee or similar fee for arranging the transaction. For some offerings, the broker-dealer may be entitled to a "trailing fee," which enables the broker-dealer to receive additional compensation based on the amount of time that the investors continue to hold the instrument.

In connection with proprietary indices or other similar arrangements, the broker-dealer may receive a license fee for granting the issuer the right to use the index. Many proprietary indices involve an ongoing index fee, in which the return profile of the index is reduced to reflect the broker-dealer's hedging costs or similar actual expenses incurred over the life of the security.

Additional fees may be received by broker-dealers in connection with their role in the transaction. For some types of securities, distributors charge so-called "shelf space fees," for making their distribution platforms available to different issuers or product manufacturers. In any potential future environment in which the new Department of Labor fiduciary duty rules or other similar fiduciary duties apply, these brokers will need to consider carefully whether these and other arrangements are permitted and appropriate.

Trading and Other Commercial Activities by the Broker-Dealer

A broker-dealer, particularly a full service one, is likely to conduct a variety of ongoing trading activities relating to the underlying assets. Some of this activity will be for its own account, and some will be for the benefit of its customers. This trading activity may or not be in the same direction as the "thesis" of the structured note, and could cause or contribute to price movements that may adversely impact holders of the structured product.

Broker-dealers not only are underwriters of securities and other structured products, but often serve as underwriters, financial advisers, or lenders to companies the securities of which may be included in the relevant underlying asset. Broker-dealers may or may not acquire information that relates to the value of these securities, which they are not obligated to disclose to investors in the structured product. As a result, broker-dealers will rely on their "control room" process to determine whether the firm is in a position to link a proposed product to specific securities. Whether or not any material non-public information would be attributed to the structuring desk, market participants are concerned about the reputational issues and potential impact on customer relations that could arise from offering a structured product while in possession of material non-public information about the relevant issuer or issuers.

Research departments of broker-dealers will publish reports about indices, sectors, individual stocks, or other assets. These reports may in many cases express a view that is adverse to the thesis of a structured product, and can be a factor that influences the direction of the underlying asset and, as a result, the value of securities linked to that underlying asset.

FINRA Advertising and Structured Products: The Current State of Play

On January 24, 2017, at the Structured Product Association's Annual Legal, Regulatory & Compliance Update, Amy Sochard, senior director of FINRA's advertising department, provided an update as to the department's review of structured product marketing materials.

Ms. Sochard provided an overview of the application of the FINRA advertising rules to structured products, and the types of documents that need to be filed with FINRA's advertising department. Then Ms. Sochard compared filing practices and FINRA's reviews from 2013 to 2016. She noted that, in 2013, approximately 746 structured product offering documents

were filed with the advertising department, compared to 129 in 2016. The reduction relates in part to changes in the FINRA rules that require fewer documents to be so filed. In terms of the types of products that were covered by these filings, she noted that in 2013, a larger portion of the filings related to more complex products, such as ETNs and curve steepener notes, while in 2016, more of the filings related to simpler products, such as market-linked CDs.

She indicated that in 2013, the advertising department made comments and requests for revisions as to approximately 88% of the documents that they reviewed; in fact, the advertising department requested that the filers cease entirely to use approximately 4% due to more significant deficiencies. In contrast, in 2016, Ms. Sochard indicated that only approximately 40% of the documents submitted required revisions. This improvement, in her estimation, related to the fact that filers had acquired more experience in complying with FINRA's rules, and had improved their risk and other disclosures. Filers also improved their graphic displays, such as charts and tables. In addition, because the filings tended to relate to simpler products, simpler disclosures could be created and filed.

Ms. Sochard concluded her presentation by noting that structured products are now being offered in the form of 1940 Act "wrappers," such as unit investment trusts. She expressed her concern that, without adequate disclosures, investors might confuse these products with more traditional mutual funds, and investors may not be made aware of their unique terms and risks. As an example of FINRA's concerns about the types of complex products that could be wrapped in a 1940 Act wrapper, she cited FINRA's Investor Alert on leveraged and inverse ETFs from August 2009. Accordingly, she encouraged market participants engaged in this area to exercise care in the preparation of marketing materials, and to train their personnel to properly sell such products.

FINRA Proposes Amendments to Communication Rules to Permit Projected Performance of an Investment Strategy

Introduction

FINRA continues its retrospective review of its communications rules.[1] In February 2017, FINRA announced it is seeking comments on proposed amendments to FINRA Rule 2210. The proposal would create an exception to the rule's general prohibition on projecting performance, which would permit a broker-dealer to distribute a customized hypothetical investment planning illustration that includes the projected performance of an asset allocation or other investment strategy. A presentation of this kind would be subject to several conditions set forth in the proposal. The proposal may be found at the following link: http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-06.pdf.

About Projections

Rule 2210 provides that, as a general matter, communications from broker-dealers may not predict or project performance, imply that past performance will recur, or make any exaggerated or unwarranted claim, opinion, or forecast. This prohibition is mainly intended to protect retail investors from performance projections of individual investments, which may be inaccurate or misleading. In the new proposal, FINRA noted that:

> "information regarding the expected performance of an asset allocation or other investment strategy that does not project the performance of individual securities could better inform an investor about assumptions upon which the recommendation to pursue such a strategy is based. Commenters to FINRA's retrospective review of the communications rules suggested that investors would benefit from projections in that more limited context and noted that investment advisers often present performance projections in their communications with their clients, particularly in communications concerning financial planning or asset allocation."

Terms and Conditions of the Proposed Amendments

The amendments would provide an exception to the prohibition of projections for a customized hypothetical investment planning illustration. An illustration could project an asset allocation or other investment strategy; however, it could not project the performance of an individual security (such as, for example, a particular structured note). There would need to be a "reasonable basis" for all assumptions, conclusions, and recommendations. The illustration must clearly and prominently disclose the fact that the illustration is hypothetical and there is no assurance that any described investment

[1] Several initial revisions to the communications rules that resulted from this review became effective in January 2017, as discussed in FINRA Regulatory Notice 16-41: http://www.finra.org/industry/notices/16-41

performance or event will occur. All material assumptions and limitations applicable to the illustration would have to be disclosed. The proposed rule would also establish specific supervisory requirements for the permitted illustrations. In connection with its proposal, FINRA discussed what would constitute a "reasonable basis," in light of its prior guidance. In doing so, FINRA restated its historical position that hypothetical back-tested performance (sometimes referred to as "pre-inception performance information") is prohibited in retail communications. However, it is possible that rule proposals of this kind may signal that FINRA is becoming more receptive to the possibility of this type of information being used. FINRA's views in this area may continue to evolve.

Applicability to Structured Product Sales and Marketing

The proposed rule would not permit projections of performance of a particular security, including a structured note. However, many structured notes represent an asset allocation or other investment strategy, such as a note linked to a basket of international indices representing different regions. In connection with discussing the possibility of such an investment, a financial advisor could utilize these rules to show a hypothetical investment planning illustration of how such a strategy might perform in different environments.

Comment Period

The proposed amendment is subject to a comment period, which expires on March 27, 2017.

Failure to Follow Compliance Policies in Connection with ETF Sales Leads to SEC Sanctions

A recent cease-and-desist order from the Securities and Exchange Commission (SEC) illustrates the types of activities and compliance issues that should be causes for concern for registered investment advisers (RIAs) when recommending non-traditional exchange traded funds (ETFs).[2]

In this case, the SEC determined that the RIA:

- did not properly address the concerns of regulators about non-traditional ETFs;
- solicited sales of single-inverse ETFs to non-discretionary advisory accounts with long-term time horizons;
- did not follow its own compliance policies and procedures regarding the suitability of such sales;
- did not follow its own compliance policies requiring its financial advisers to monitor their clients' positions on an ongoing basis;
- made some of those recommendations through financial advisors who were inadequately trained;
- did not sufficiently address concerns relating to these sales in response to the findings of its own internal audit; and
- did not sufficiently respond to examiners' concerns about such sales.

As a result, the RIA was the subject of a SEC cease-and-desist order for violations of the Investment Advisors Act of 1940 (Advisers Act), and remedial sanctions.

A History of Regulatory Concerns with Non-Traditional ETFs

Non-traditional ETFs and single inverse ETFs have been a concern for regulators for years.[3] In June 2009, the Financial Industry Regulatory Authority, Inc. (FINRA) issued Regulatory Notice 09-31, in which it reminded member brokerage firms of their sales obligations with respect to such ETFs. Among other items, Regulatory Notice 09-31 highlighted the importance of a FINRA member's suitable recommendations and adequate supervisory policies in connection with sales of such ETFs. In particular, Regulatory Notice 09-31 stated that "inverse and leveraged ETFs typically are not suitable for retail clients who plan to hold them for more than one trading session, particularly in volatile markets."

[2] The SEC order can be found at: https://www.sec.gov/litigation/admin/2017/ia-4649.pdf.
[3] A SEC Investor Alert and Bulletin on Leveraged and Inverse ETFs can be found at: https://www.sec.gov/investor/pubs/leveragedetfs-alert.htm. FINRA Regulatory Notice 09-31 can be found at: http://www.finra.org/industry/notices/09-31.

Here, the RIA's parent company, a FINRA member, was sanctioned by FINRA in 2012 and by a state securities regulator in 2013 for its lack of compliance policies prior to 2009 with respect to sales of non-traditional ETFs, including single inverse ETFs.

The RIA's Response – A Comprehensive Set of Compliance Policies

After Regulatory Notice 09-31 was issued, the RIA created a comprehensive set of compliance policies intended to protect against its financial advisers making unsuitable recommendations of non-traditional ETFs, including single-inverse ETFs, to advisory clients. The compliance policies were designed to prevent violations of the Advisers Act, including its anti-fraud provisions. However, over time, the initially strict policy was weakened.

In 2010, the RIA allowed its advisers to recommend certain single-inverse ETFs to non-discretionary accounts, but only if particular safeguards were satisfied. Prior to placing a single inverse ETF into a non-discretionary advisory account, the RIA was to obtain from the client an executed "Client Disclosure Notice," which explained the risks involved with such ETFs, including that these products were unsuitable for clients planning to hold them for more than one trading session, unless part of a hedging strategy. The Client Disclosure Notice also warned that the performance of the ETF over periods of greater than one day could differ significantly than the performance of the underlying reference asset. Clients were required to sign the notice, acknowledging that they understood the risks involved with single-inverse ETFs and that they agreed to make the investment, and the RIA was to maintain a record of the executed notice.

As a further safeguard, the RIA's policy required that the financial adviser consider whether an investment in a single-inverse ETF would be appropriate for the client under a suitability analysis, and that the financial adviser complete training in single-inverse ETFs prior to recommending an investment. Prior to a client's purchase, a manager of the RIA was to conduct a risk review, considering the client's investment experience, whether the Client Disclosure Notice had been signed, whether the client's stated investment objectives and time horizon were consistent with the transaction, the size of the transaction/position relative to the client's financial position, and any other relevant considerations. The financial adviser was also supposed to monitor the index or benchmark underlying the ETF and the ETF's performance relative to the benchmark and to consider the appropriateness of the hedging strategy.

Recommendations of purchases of non-traditional ETFs were limited to client's using them as part of a hedging strategy, rather than for speculation purposes. However, in 2014, the hedging requirement was dropped.

Inconsistent Application of the Compliance Policies

Despite the best intentions, the RIA did not consistently enforce its own well-designed set of compliance procedures. The RIA did not obtain executed Client Disclosure Notices for sales of single-inverse ETFs into about 44% of its non-discretionary trading accounts, which was a violation of the books and records provisions of the Advisers Act. Many of these accounts held the ETFs for at least 30 days, and incurred significant losses. Some of these accounts were retirement accounts with long-term time horizons. Risk reviews by managers were deemed by the SEC's Office of Compliance Inspections and Examinations (OCIE) to be deficient, or did not happen at all. Even prior to dropping the hedging requirement in 2014, implementation of that requirement was not enforced to the extent deemed appropriate by the OCIE.

Examiners' Concerns Inadequately Addressed

In 2010, the OCIE conducted an examination of the RIA and identified weaknesses and made best practice recommendations regarding the RIA's monitoring of transactions in single-inverse ETFs. The OCIE noted weaknesses with the RIA's documentation of risk reviews and monitoring of the hedging requirement. The RIA responded to both of the OCIE's concerns by stating that it did not believe that further enhancements to its procedures were necessary.

Starting in 2012, the RIA performed internal testing of its ETF strategy, finding a number of deficiencies. The RIA addressed the deficiencies on a branch-by-branch basis, but did not address the issues firmwide. The RIA's internal audit found that management lacked effective controls to monitor the ongoing review of single-inverse ETFs. Limited steps were taken by the RIA to improve implementation of its policies, but compliance deficiencies continued.

In mid-2015, after the SEC enforcement staff completed its investigation, the RIA revised its compliance policy to prohibit the recommendation of any single-inverse ETFs to clients in non-discretionary advisory accounts.

Investment Advisers Act Violations

The SEC's cease-and-desist order stated that the RIA willfully violated the anti-fraud provisions of Section 206(4) of the Advisers Act and the requirements to maintain policies and procedures designed to prevent violations of the Advisers Act under Rule 206(4)-7.

Conclusion

The lesson is clear: well-designed compliance procedures must be properly followed in order to adequately protect investors and to avoid negative attention from regulators.

Broad-Based vs. Narrow-Based Indices

What criteria render an index "broad-based" or "narrow-based"? Depending who you ask, you're likely to receive a wide range of response. This is because, under the relevant U.S. securities, commodities, and tax laws, there are different definitions used. These differences reflect the historical positions taken by the relevant regulators, in light of the markets they were regulating, and the results that they were seeking to achieve.

To illustrate this diversity, we have prepared the table below. The table identifies how a number of different U.S. regulators view these issues, and the criteria that they apply.

	Authority	Minimum Number of Components	Minimum Market Value	Minimum Trading Volume	Weighting
1	**Securities Exchange Act of 1934 Section 3(a)(55) / Commodity Exchange Act Section 1a(35) – "Path A"** – "not a narrow-based security index"	10	None	The lowest-weighted component securities comprising 25% of the index's weighting have an aggregate value of average daily trading volume of $50,000,000 or more (or in the case of an index with 15 or more component securities, $30,000,000)	(1) No underlying component security comprises more than 30% of the index's weighting and (2) the highest-weighted component securities in the aggregate may not comprise more than 60% of the index's weighting
2	**Securities Exchange Act of 1934, Section 3(a)(55) / Commodity Exchange Act Section 1a(35) – "Path B"** – "not a narrow-based security index"	9	One of 750 securities with the largest market capitalization	One of 675 securities with the largest dollar value of average trading volume	No underlying component security will represent more than 30% of the weight of the index

	Authority	Minimum Number of Components	Minimum Market Value	Minimum Trading Volume	Weighting
3	**IRS General Counsel Memorandum ("GCM") 39316 (July 31, 1984)**[4] – "A "broadbased index" is one based on a large number of securities, such as the Dow Jones or the Standard and Poor average. … We recommended that the Service generally follow the broad and narrow-based determinations made by the SEC and CFTC."	11	None	None	None
4	**Treas. Reg. 1.871-15(l)(3)** – broad-based safe harbor for "qualified indices"	25	None	None	(1) No component underlying security represents more than 15% of the weighting of the component securities in the index and (2) no five or fewer component underlying securities together represent more than 40% of the weighting of the component securities in the index
5	**Internal Revenue Code 1256(g)(6)(B)** – "narrow-based security index (as defined in section 3(a)(55) of the Securities Exchange Act of 1934, as in effect on the date of the enactment of this paragraph)."[5]	*See* rows 1 and 2	*See* rows 1 and 2	*See* rows 1 and 2	*See* rows 1 and 2
6	**Treas. Reg. 1.246-5(c)(1)(i)** – "A portfolio [of stock]… is any group of stocks of 20 or more unrelated issuers"	20	None	None	None

[4] GCM 39316 held that the determination of the issuer for purposes of Section 851 in the case of an instrument based on a stock index depends on whether the index is "narrow-based" or "broad-based." At the time of GCM 39316, the SEC and the CFTC determined on a case-by-case basis whether any particular proposed index option/future is broad- or narrow-based. This determination is now set forth in Section 3(a)(55) of the Securities Exchange Act and Section 1a(35) of the Commodity Exchange Act. GCM 39316 was reconsidered in and modified by GCM 39708 (November 16, 1987), in which the Chief Counsel's Office concluded that the issuers of an option on a stock index are the issuers of the stocks underlying the index irrespective of whether the index is "broad-based" or "narrow-based."

[5] Section 1256(g)(6)(B) was enacted on December 21, 2000. Section 3(a)(55) of the Securities Exchange Act has not been amended since December 21, 2000.

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Upcoming Events

7th Annual Financial Services, Regulatory and Compliance Conference
Wednesday, March 8, 2017
Morrison & Foerster Seminar, 8:45 a.m. – 5:15 p.m. EST

The Ritz-Carlton Charlotte
201 East Trade Street
Charlotte, NC 28202

Please join Morrison & Foerster attorneys as we offer our insights regarding the future of financial services regulation. The morning sessions will focus on consumer financial services and privacy and cybersecurity developments. The afternoon sessions will focus on wholesale, capital markets and tax developments.

For more information, or to register for the conference, please click here.

CLE credit is pending for North Carolina, California and New York.

SEC in 2017 – What's Next? SEC Veterans Weigh In
Thursday, March 9, 2017
ALI CLE Webinar, 12:30 p.m. – 2:00 p.m. EST

As the Trump Administration takes charge in 2017, the only thing that seems inevitable is that the regulatory and enforcement outlook will change. Initial indications point to a desire to relax or repeal certain regulations that may be regarded as burdensome to public companies. Also, proposed legislation would relax certain corporate governance and compensation-related measures that formed part of the Dodd-Frank Act. Proposed legislation also would address the types of cost-benefit analysis that would be required to support proposed regulation.

Don't miss this chance to learn SEC regulations' status and how they will likely change from experts who have been directly involved in rule-making and implementation of U.S. securities laws.

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

Please contact cmg-events@mofo.com for a promotional code for discounted $99 tuition.

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

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, and Fortune 100, technology and life sciences companies. We've been included on *The American Lawyer*'s A-List for 13 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. © 2017 Morrison & Foerster LLP. All rights reserved.

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