Morrison & Foerster News Bulletin
Volume 7, Issue 11 November 17, 2016

Structured Thoughts

News for the financial services community.

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Structured Products Legal and Regulatory Conference: November 2016

In November 2016, Morrison & Foerster LLP sponsored *Risk* magazine's annual structured products legal and regulatory conference in Washington, D.C. Securities, tax, and ERISA practitioners at the firm participated in most of the panel discussions.

For a summary of the key messages at the conference, presented by regulators, in-house counsel, product structurers, and attorneys in private practice, please see the following summary in *Risk*: www.risk.net/2477376.

In this article, we will summarize a few additional subjects raised at the conference.

International Regulators: How They Learn About the Structured Products Market

U.S. and Canadian regulators discussed the means that they use to follow developments in the rapidly changing structured products market. In addition to attending seminars such as the Washington conference, these regulators:

- Share information with one another about interesting structures and new prospectuses;
- Obtain information from outside consultants, including individuals who may have previously held senior positions in the structured products industry; and
- Review media coverage, including both industry publications and newspapers and magazines with broader circulation and broader industry coverage.

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Dealer Agreements

A panel covering know your distributor (KYD) and other relationships between underwriters, dealers and downstream dealers started off with a discussion about balancing the need for KYD with avoiding unnecessary intrusiveness during diligence. In its 2013 report on conflicts of interest, FINRA provided recommendations for dealers conducting diligence on the practices of their potential business partners in a distribution. The panelists discussed concerns about a dealer avoiding taking a "big brother" approach in this type of relationship. Another area of concern was that, where a dealer may be the issuer's hedge counterparty for a transaction, KYD procedures should ensure proper separation between trading and sales functions, so that the dealer's sales desk is not given an incentive to sell notes in order to generate hedging profits for the dealer.

One panelist explained how technology tools such as a daily "scrape" of news articles, FINRA's Brokercheck and other sources on both the FINRA members and their associated persons, can be used as part of the KYD process as to particular dealers.

In the area of conflicts of interest, the panelists discussed proper disclosure of any preferred sales relationship between dealers in an offering, particularly if a dealer is receiving any kind of special incentive to participate in the offering. The disclosure can become more complicated if a dealer plays multiple roles, such as also being a calculation agent for the security or serving as the sponsor of a proprietary index.

The panelists talked about concerns raised when a distributor requests that a "custom" risk factor be added to an issuer's disclosure document for a particular offering, particularly where such a risk factor may be immaterial or apparently not legally required under the circumstances. Issuers must balance this type of request against the potential for creating bad optics if one distribution channel has a particular risk factor and another distribution channel for the same product does not.

Recurring and potentially troublesome aspects of dealer agreements were then discussed. The panelists discussed how underwriters and dealers are addressing concerns about potential liability resulting from non-U.S. sales and methods to limit that liability. The solutions discussed included limiting a dealer's non-U.S. sales to an agreed upon list of jurisdictions, and using a dealer with expertise in particular non-U.S. jurisdictions.

Dealer demands for diligence items such as opinions, comfort letters and officers' certificates were discussed next, along with how issuers and their affiliated underwriters respond to those requests. The panelists discussed the circumstances under which these requests are raised and potential solutions to address dealer concerns.

Market Conditions

The conference's final panel consisted of front-office representatives of Bank of America Merrill Lynch, BNP Paribas and HSBC. The panelists discussed how the significant legal and business events of the past year impacted the nature of the products that were issued and the volume of offering activity: the DOL's release of its final rules, changes in the interest rate environment, and the U.K.'s Brexit vote. The table on the following page compares, on a monthly basis, 2016 issuances of registered structured notes compared to 2015 issuances. Panelists noted that aggregate issuances may be lower than they were through the month of the Brexit vote, but have recovered well on a month-to-month basis since the vote.

Average issuance sizes have decreased a bit by bit, year over year, although the 2015 average size was increased somewhat due to a number of extremely large issuances towards the beginning of 2015. Issuances are trending towards an increased portion of index-linked products, as opposed to individual common stocks.

Panelists emphasized the industry's continuing commitment to creating products that can provide significant and tailored benefits to investors seeking to manage different types of market risks. Product innovation will continue, with a view to achieving these goals.

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2015			2016			Delta of amount raised 2015 vs. 2016 (in billions)
Month	Amount raised (in billions)	Number of deals	Month	Amount raised (in billions)	Number of deals	
15-Jan	$5.07	727	16-Jan	$4.68	694	-$0.38
15-Feb	$3.70	735	16-Feb	$2.42	572	-$1.28
15-Mar	$4.18	807	16-Mar	$3.15	652	-$1.03
15-Apr	$3.97	746	16-Apr	$2.60	656	-$1.37
15-May	$4.27	776	16-May	$2.88	709	-$1.39
15-Jun	$3.79	697	16-Jun	$2.33	751	-$1.45
					FIRST HALF 2016 TOTAL DIFFERENCE:	-$6.90
15-Jul	$3.31	707	16-Jul	$3.31	752	$0.00
15-Aug	$3.07	730	16-Aug	$3.19	870	$0.12
15-Sep	$3.06	709	16-Sep	$3.59	921	$0.53
15-Oct	$3.41	596	16-Oct	$3.09	798	-$0.32
					YEAR TO DATE 2016 TOTAL DIFFERENCE:	-$6.57

Source: *Prospect News*

Riskless Principal Transactions

Introduction

In connection with our examination of the Department of Labor's new fiduciary rules, and potential offerings conducted under the "BIC Exemption," we recently examined offerings of structured notes on an "agency basis."[1]

In this article, we discuss an alternative offering methodology that may be used under the BIC Exemption, "riskless principal" transactions.

The BIC Exemption is not available for use in a principal transaction, where the broker-dealer sells a product from its "inventory" and resells it to a retirement investor. However, the BIC Exemption contemplates the possibility of sales on a "riskless principal" basis. It defines a transaction of this type as "a transaction in which a [Financial Institution] purchases or sells [the notes] for [its] own account to offset the simultaneous transaction with the [Retirement Investor]."

Accordingly, this type of transaction seems suited for many types of offerings that are made to retirement investors. That is, in a typical structured note offering, the broker-dealer will purchase the notes from the applicable issuer based upon the amount of "indications of interest" received from its investors, including retail retirement investors that are subject to the DOL rules. In most offerings, the broker-dealer will not purchase the notes unless it has customer orders. (In contrast, in some offerings, a broker-dealer will base its purchase amount upon the amount that it expects to be able to sell, without necessarily tying that amount to the number of orders received.) At the time of settlement, the broker-dealer's settlement of its purchase of the notes occurs simultaneously with its sale of the notes to the end investors; the broker-dealer does not "own" the notes in its own account for a significant period of time.

In a sense, many transactions have already been conducted on this basis, although they have not necessarily been described in this manner. For example, most program agreements providing for the sale of structured notes discuss the possibility of a broker-dealer acting as "principal" or as "agent," but do not address riskless principal transactions as a separate category.

[1] See https://media2.mofo.com/documents/160527structuredthoughts.pdf.

Broker-dealers who are considering fitting these types of transactions into the BIC Exemption may wish to consider a variety of issues, including:

- Are any changes to their distribution agreements needed or appropriate to effect this manner of sale? For example, should any changes be made to address situations in which the ultimate purchaser cancels an order, or fails to settle on the closing date?
- Since brokerage confirmations typically address only the "principal" and "agent" dichotomy, are changes appropriate to reflect these types of sales? If so, what modifications might be needed to a broker-dealer's technology systems to recognize these types of transactions?
- How are these transactions accounted for in considering the broker-dealer's own regulatory capital requirements? Are there other transactions effected by broker-dealers, outside of the structured note context, that do or should have similar treatment?

Of course, the characterization of a transaction as a "riskless principal" transaction (or a permitted "agency" transaction) is one of many requirements that must be satisfied for the use of the BIC Exemption, and to protect against potential claims long after the transaction is completed. Brokers are currently working to evaluate the wide range of conditions that need to be satisfied, in order to determine the extent to which structured products and other complex instruments can be appropriately sold under this exemption.

Department of Labor Issues Initial Guidance on Fiduciary Rule

In October 2016, the U.S. Department of Labor issued its first guidance, in the form of frequently asked questions, about its new fiduciary rules. In the absence of any additional governmental action, whether by the Obama administration, or the incoming administration, the new regulations will become effective in April 2017.

FAQs address in large part a variety of compensation questions that have been raised by both broker-dealer firms and their financial advisers. However, this set of FAQs does not address most of the key questions that have been of concern to the structured products industry, such as the definition of the term "proprietary product," and the permissibility of different offering methodologies under the BIC Exemption.

For our client alert about the FAQs, see: https://media2.mofo.com/documents/161031-dol-guidance-fiduciary-rule.pdf.

Summary of DOL Conflict Rule, BICE and Principal Transaction Exemption

Morrison & Foerster has prepared an easy to follow flow chart summarizing the DOL Conflict Rule, BICE and Principal Transaction Exemption, see:
https://media2.mofo.com/documents/161116-summary-of-dol-conflict-rule-bice.pdf

ETN Issuers Affected by Proposed Changes to Nasdaq Listing Rules

On September 30, 2016, Nasdaq submitted to the Securities and Exchange Commission a proposal to amend certain continued listing requirements for exchange-traded products in the Rule 5700 series and related amendments.[2]

For issuers of exchange traded notes listed on Nasdaq, most of the changes are minor. Some of the initial listing requirements will become applicable on a continuous basis. For example, the initial listing requirements of Nasdaq Rules 5710(a) and 5730(a) relating to minimum assets and stockholders' equity of the issuer will now apply on a continuous

[2] The Nasdaq proposal can be found at: http://nasdaq.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2016/SR-NASDAQ-2016-135.pdf.

basis. Similarly, the issuer's minimum tangible net worth requirement of Nasdaq Rule 5710(e) will apply on a continuous basis. For large ETN issuers, meeting these requirements on a continuous basis should not be difficult.

However, the change from an initial to a continuous listing requirement with respect to a minimum outstanding aggregate market value/principal amount of at least $4 million may affect some ETN issuers. This $4 million amount includes ETNs held by affiliates of the issuer, such as a broker-dealer. ETN issuers have always had to satisfy this requirement at the time of issuance and initial listing, but were not subject to a delisting unless the publicly held aggregate market value/principal amount fell to less than $400,000 (see Nasdaq Rule 5710(K)(i)(B)(3)(a), NYSE Arca Rule 5.2(j)(6)(B)(I)(2)(c)(i) and BATS Rule 14.11(d)(2)(K)(i)(b)(3)(A)).[3] ETN issuers of thinly-traded ETNs may fall below the $4 million outstanding threshold due to redemptions and market-making repurchases, but could avoid a delisting by issuing additional ETNs to an affiliate.

The other requirements that will now apply on a continuous basis, in addition to at the time of the initial listing, are that the ETN must be non-convertible debt of the issuer, negative leverage is limited to 3x, and if the ETN is linked to an index and that index is maintained by a broker-dealer, the broker-dealer must maintain a firewall around personnel maintaining the index.

A proposed change to Rule 5701 will require an executive officer of an issuer of any security listed under the Rule 5700 series to notify Nasdaq after the officer becomes aware of any non-compliance with the requirements of that series.

Inside FINRA's "Cross-Selling Sweep"

In response to recent highly-publicized scrutiny of bank cross-selling practices, FINRA announced in October 2016 that it is conducting a sweep of broker-dealers to determine the extent to which they are:

- promoting bank products of affiliated or parent companies to broker-dealer retail customers; and
- adding different features to broker-dealer retail customer accounts such as securities-based loans, or opening additional broker-dealer accounts.

A copy of the sweep letter may be found at the following link on the FINRA website: http://www.finra.org/industry/review-cross-selling-programs.

The sweep letter has a very broad scope, and requests a wide range of information about broker-dealer policies, procedures and practices relating to cross-selling, including the potential compensation to employees for such cross-selling. In light of recent events, the sweep letter conveys a particular interest in determining whether any of these products were sold without customer authorization.

The inquiry also requests copies of marketing materials used by broker-dealers to advertise bank products that are subject to the sweep. Of course, for some market participants with a robust array of financial products, the amount of documents required to be delivered under the sweep could be somewhat voluminous.

The inquiry mentions "bank products" without defining that term. On its face, the term would appear to cover structured products and instruments such as CDs and structured bank notes, which are issued by a bank. However, the term may not necessarily cover structured notes issued by a bank holding company. That being said, because the letter also refers to broker-dealer parent companies, the request arguably relates to structured notes and other instruments issued by parent corporations, particularly in light of the potential conflicts of interest that can arise from cross-selling programs.

To a significant extent, this new sweep letter requests information that may have been provided to FINRA through prior sweeps. For example, February 2016's sweep relating to firm culture (http://www.finra.org/industry/establishing-communicating-and-implementing-cultural-values) requested information as to a variety of compensation practices that could impact how sale determinations are made. Similarly, FINRA's August 2015 sweep relating to compensation and conflicts of interest (http://www.finra.org/industry/conflicts-interest-review-compensation-and-oversight) explored the manner in which some compensation programs may inappropriately incentivize financial advisors to sell products that may not be appropriate for customers.

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[3] ETNs held by an affiliate of the issuer would not be considered "publicly held" under Nasdaq Rules 5710(K)(i)(B)(3)(a) and 5005(a)(34).

The recent publicity concerning cross-selling programs likely reflects a concern on FINRA's part that its prior guidance may not have been properly followed, and its concerns not properly addressed, with respect to these types of programs. The results of the sweep, and any follow-up actions by FINRA, may reveal the extent to which FINRA is satisfied as to the efforts that broker-dealers are making regarding the conflicts of interest that may arise in these types of incentive programs.

Extension to Implementation Date of PRIIPs Regulation

On November 9, 2016, the EU Commission issued a press release stating that it was proposing a one year extension to the implementation date for the Regulation on Key Information Documents for Packaged Retail and Insurance-based Investment Products (the PRIIPs Regulation). The PRIIPs Regulation was due to apply from December 31, 2016. The EU Commission has published a draft amending Regulation which will delay the commencement date to January 1, 2018.

The PRIIPs Regulation applies to manufacturers and distributors of PRIIPs, and provides that where a PRIIP is to be made available to retail investors, a Key Information Document (KID) must be prepared and provided to those investors. The requirements as to the form and content of the KID are detailed and prescriptive. The KID must be a maximum of three sides of A4-sized paper.

In connection with the PRIIPs Regulation, the European Supervisory Authorities (ESAs)[4] published draft Regulatory Technical Standards (RTS) which contain additional detail on the content requirements for the KID, detailed methodology related to certain required elements, and a draft template for the KID. The RTS were adopted by the EU Commission in June 2016, which then proposed a draft delegated regulation to give effect to them. However, this process subsequently ran into difficulty with the EU Parliament, which raised a number of concerns on the draft RTS; these concerns included the methodology for the calculation of future performance scenarios, and the lack of detailed guidance on how the required "comprehension alert" should be structured. The EU Parliament formally rejected the proposed delegated regulation on September 14, 2016. It also called for a delay in the implementation timetable for the PRIIPs Regulation, in order to give time for revised RTS to be finalized.

Even prior to this time, many market participants and trade bodies had called for a delay in the PRIIPs implementation timetable. In addition to concerns about the draft RTS and the time needed for market participants to prepare product-specific templates for their KIDs, it was also noted that further guidance in the form of Q&As that the EU Commission had indicated would be published well in advance of the implementation date, had still not been made available. Although the EU Commission indicated that it might be prepared to proceed with the implementation of the PRIIPs Regulation without the finalization of the RTS, this approach was regarded as impracticable by many in the industry in view of the lack of detailed rules on the content of the KID in the PRIIPs Regulation, coupled with the potential for liability and/or sanctions for manufacturers if any KID did not comply with the PRIIPs Regulation.[5]

In its press release, the EU Commission stated that it is working closely with the ESAs to resubmit draft RTS, with a view towards meeting some of the concerns raised by the EU Parliament and developing guidance notes, particularly in relation to the practical application of credit risk mitigation factors for providers of insurance-based products. The Commission indicated that the revised RTS should be submitted to it by the end of 2016. with a view to them being finalized within the first half of 2017.

The Commission's amending regulation needs to be approved by the EU Parliament and EU Council of Ministers. It is not expected to face any objections in principle to the delay; however, it is not straightforward to finalize EU legislation in a short time frame. Concerns therefore remain about whether the amending regulation will be in force prior to the current PRIIPs Regulation implementation date. The delay is likely to be welcome by most participants in the structured products industry. That being said, there will still be concerns about the extent to which revised RTS developed in the course of the next six weeks will be able to meet the concerns that were previously raised. Nevertheless, the revised time frame for finalization of the RTS and guidance notes and implementation of the PRIIPs Regulation are likely to be regarded as much more workable than the current position.

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[4] The ESAs comprise the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA).
[5] See letter from the Joint Associations Committee to the EU Commission on 17 October 2016, https://www2.isda.org/asset-classes/structured-products/.

Cheat Sheets

We have produced a few quick reference summaries of various regulations that may be of interest to readers. These are accessible from the following links:

- Liquidity Coverage Ratio ("LCR") Summary
- Total Loss Absorbing Capacity ("TLAC") – Financial Stability Board Principles
- Total Loss Absorbing Capacity ("TLAC") – Federal Reserve Proposed Rule
- New Executive Compensation Rule At-A-Glance
- Net Stable Funding Ratio ("NSFR") – Proposed Rule

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, disseminate 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.

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

Morrison & Foerster was named 2016 Americas Law Firm of the Year for the second year in a row by *GlobalCapital* for its Americas 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*.

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