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Structured Thoughts

News for the financial services community.

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LIBOR: The End Game

Since the announcement on July 27, 2017 by the UK Financial Conduct Authority (the FCA) that the LIBOR rate would be phased out after 2021, much has been written about the complications of switching over from LIBOR to an alternative rate. It is reported that LIBOR is tied to over $350 trillion in derivatives, corporate bonds, and other financial products (such as adjustable rate mortgages). Although efforts to strengthen LIBOR have been ongoing, there are simply not enough underlying transactions upon which a LIBOR quote can be reliably based, according to FCA Chief Executive Andrew Bailey.

Killing off LIBOR inevitably raises questions about how a transition to a replacement rate would work. For GBP LIBOR, the Sterling Overnight Index Average, or SONIA, has been put forth as a replacement. One might question whether SONIA is a perfect fit for replacing a LIBOR instrument, as SONIA is solely an overnight rate, while LIBOR has a range of tenors from overnight to 12 months.

In the United States, the Alternative Reference Rates Committee recommended the “Secured Overnight Financing Rate” (SOFR) as a replacement for USD LIBOR. Again, there would be transitional issues, as LIBOR is forward-looking and unsecured, and has a range of tenors, while the replacement rate is an overnight, secured, and backward-looking rate.[1]

How would this all affect existing structured products and floating rate notes based on LIBOR? As opposed to derivatives contracts negotiated between two parties, who could agree to amend the documentation to switch to a new rate, beneficial interests in corporate bonds are held by many parties. Under a standard indenture, changing the interest rate would require the consent of all of the holders; i.e., a consent solicitation, a costly exercise. Absent an industry-wide

[1] On August 24, 2017, the Board of Governors of the Federal Reserve System invited public comment on three new rates to be published by the Federal Reserve Bank of New York, all based on data for overnight repurchase agreement transactions on Treasury securities, one of which is SOFR. The request for comment can be found here.

agreed replacement rate for LIBOR, it's hard to imagine bond holders, being 100% in agreement on replacing the existing LIBOR rate without a sweetener.

What options do issuers have for future issuances of LIBOR-linked notes with maturities of longer than four years? Some options, all of which would be built into the documentation and would take effect upon a defined LIBOR "termination," are:

- Agreeing on a replacement rate;
- Agreeing to adopt a rate considered by the International Swaps and Derivatives Association, Inc. (ISDA) to be a LIBOR replacement; or
- Defaulting to calculation agent discretion in picking a replacement rate.

Issuers will also have to agree on what constitutes a termination of LIBOR. In a recent ISDA presentation, four possibilities were put forward as IBOR terminations, each of which would trigger the use in derivatives contracts of revised fallback provisions using a replacement rate:

- The insolvency of the relevant IBOR administrator (and there is no successor administrator);
- A public statement by the relevant IBOR administrator that it will cease publishing the relevant IBOR permanently or indefinitely (and there is no successor administrator that will continue publication of the relevant IBOR);
- A public statement by the supervisor for the relevant IBOR administrator that the relevant IBOR has been permanently or indefinitely discontinued; or
- A statement by the supervisor for the relevant IBOR administrator that the relevant IBOR may no longer be used.[2]

Although LIBOR rates may still be published by ICE Benchmark Administration, there is no guarantee either that there will be sufficient transactions for the submitting panel banks to report, or that the number of panel banks would not fall below the current number (17 for USD LIBOR). The FCA recently announced that it would use its "compulsion powers" to force banks to contribute to setting the LIBOR rate "only where it would be appropriate to ensure market integrity or consumer protection."[3] In addition to the proposed ISDA termination events listed above, issuers may want to define LIBOR as being terminated if, for example, despite the FCA's compulsion efforts, there were only six submitting panel banks.

For additional discussion and analysis relating to issues arising from the potential termination of LIBOR, please see our recent publication, "Replacing Familiar Benchmarks: Preparation to Phase out the IBORs," which may be found here.

Structured Notes and Regulation M: A Primer

Introduction

SEC Regulation M is designed to help ensure the integrity of the securities markets. It prohibits certain activities by distribution participants (such as issuers, underwriters, and selling group members) that could potentially manipulate the market for a security that is the subject of an offering. In this article, we discuss some of the key ways in which this regulation impacts the market for structured notes.[4]

We note that Regulation M concerns market manipulation; however, it is a prophylactic rule, and prohibits certain conduct, whether or not that conduct involves any fraudulent intent. Accordingly, market participants need to have a good understanding of the rule and its provisions in order to avoid an inadvertent violation of the rule.

[2] These termination events would apply to all of the interbank offered rates (IBORs) for various currencies, not just LIBOR (e.g., TIBOR, EURIBOR, etc.). The new IBOR fallbacks will be included in the 2006 ISDA Definitions through an amendment and, therefore, will be automatically incorporated into derivatives contracts executed after the date of that amendment. For derivative contracts entered into prior to the amendment to the 2006 ISDA definitions, ISDA discussed a protocol that would facilitate amending existing contracts to incorporate the new IBOR fallbacks.
[3] *See* "FCA Mulls Powers to Force Banks to Help Set Libor" (*Law360*, June 12, 2017).
[4] For additional information about Regulation M, including how it applies to exchange-traded notes, please see our "Frequently Asked Questions About Regulation M" (the "FAQ"), which may be accessed here.

Prohibited Activities

Rule 101 of Regulation M prohibits distribution participants and their affiliated purchasers from bidding for, purchasing, or attempting to induce any person to bid for or purchase a security covered by the rule during a "restricted period."[5] For example, if additional notes of an outstanding series of structured notes are being marketed in a reopening" the relevant underwriter would not be permitted to post a bid to purchase outstanding notes in market-making transactions, absent an exemption.

Relevant Distributions

Regulation M's key provisions, Rule 101 and 102, apply in connection with a distribution. Rule 100 defines a "distribution" as a securities offering that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and methods. In the context of structured notes, typical market-making transactions will not constitute a distribution. However, a registered shelf offering of structured notes, bank note offerings, and even private offerings affected under Regulation D may all constitute a distribution.

Covered Securities

"Covered securities" are securities that are the subject of a distribution or a reference security. A reference security is a security into which the covered security may be converted, exchanged or exercised, or which may impact the value of the covered security. Derivative securities are not subject to Rule 101 and, therefore, an offering participant can bid for or purchase options, warrants, rights, convertible securities, or equity-linked securities without violating Rule 101.[6] However, during a distribution of derivative securities, such as a structured note linked to a common stock, Rule 101 does apply to the underlying security, the value of which affects the return of the derivative security.[7] In practice, equity-linked notes tend to be linked to common stocks that would constitute "exempt securities" under Regulation M – they have a worldwide average daily trading volume (ADTV) of at least $1 million and are issued by an issuer with a public float value of at least $150 million, enabling the offering participant to purchase these securities even while a related structured note is being offered.

Rule 101 vs. Rule 102

Under Regulation M, Rule 101 applies to distribution participants, such as underwriters, and their affiliated purchasers. Rule 102 applies to issuers and their affiliated purchasers.

Rule 102 prohibits the same activities during the same restricted period as Rule 101. It has comparable exemptions to Rule 101, but it does not have all of Rule 101's exemptions. While issuers must comply with Rule 102, affiliated purchasers of the issuer may comply with either Rule 101 or Rule 102. This is important because Rule 101 is generally less restrictive than Rule 102, broker-dealer affiliates of financial holding companies may comply with Rule 101 as to their parent company's securities. In the structured notes market, these broker-dealers are frequently offering and purchasing their parent company's securities. As a result, the following sections of this article principally focus on the requirements and exemptions of Rule 101, where most of the action occurs.

The Rule 101 Restricted Period

Rule 101 applies only during the applicable restricted period. For most structured notes, the restricted period begins on the later of five business days prior to the pricing date of an offering (or the time at which a person becomes a distribution participant) and ends on the completion of its participation in the distribution. Structured notes are typically offered on a "riskless principal" basis, in the sense that broker-dealers do not hold inventory, and only purchase from the issuer the aggregate principal amount for which they have orders from investors. Accordingly, for a typical structured note offering, the distribution is completed on the pricing date itself.

In contrast, if any of the notes are taken for the underwriter's own investment (an "unsold allotment"), the underwriter could resell the securities under a current prospectus or sell the securities after a significant holding period. The SEC usually presumes that an investment bank that has purchased securities from the issuer in a primary offering does not have the requisite investment intent to avail itself of exemptions from registration. Accordingly, subject to the discussion

[5] Regulation M restricted periods are discussed below.
[6] *See* Regulation M Adopting Release at page 524 here.
[7] *Id* at page 524.

below about investment grade nonconvertible securities, most practitioners advise that an underwriter hold securities that form part of an unsold allotment for a substantial period of time before reselling them.

Investment Grade Nonconvertible Securities

Rule 101 includes an exemption that is of significant interest in the structured note market: investment grade nonconvertible securities. "Investment grade" debt securities are rated by at least one nationally recognized statistical rating organization in one of its generic rating categories that signifies investment grade. In the Regulation M adopting release, the SEC noted that the exception for investment grade nonconvertible debt securities is based on the fact that these securities trade principally on the basis of their yields and credit ratings and, therefore, are less susceptible to manipulation.

Regulation M does not contain a definition of a "nonconvertible debt security"; however, in practice, this term is understood to apply to debt securities that are not convertible or exchangeable for equity securities of the same or of a third-party issuer. Similarly, many practitioners are of the view that nonconvertible debt securities that have not received an individual rating but are of the same class or series as, and are considered *pari passu* with, other investment grade rated securities of the same issuer should be treated as investment grade for purposes of Regulation M.

As a result, many practitioners believe it is reasonable to conclude that an issuer's rate-linked notes, which are *pari passu* with that issuer's investment grade rated nonconvertible "plain vanilla" debt securities, including rate-linked notes that reference the performance of commonly used interest rate benchmarks, such as LIBOR, ISDAFIX, and CMS, are "nonconvertible debt securities" for purposes of the Rule 101 and Rule 102 exclusions. That conclusion is not necessarily impacted by the particular payoffs, economic terms, or optionality of these rate-linked notes. For example, the conclusion would apply to zero coupon notes (fixed, callable, and accreting), fixed-to-floating or floating-to-fixed rate notes, capped callable notes, notes with floors or collars, step-up callable notes, and CPI-linked notes, as well as securities that have terms that include different types of contingencies in the note terms, such as range accruals. We note that, in considering the predecessor to Regulation M, Rule 10b-6, the SEC, in its 1982 proposing release for amendments to Rule 10b-6,[8] specifically discussed and rejected the notion of limiting the exclusion for nonconvertible investment grade debt to "fixed rate" instruments and noted that there was no basis for excluding securities tied to a benchmark.

This view is relied upon by market participants for making a market in outstanding securities of an issuance of this type, while holding an inventory of them for potential issuances to additional investors.

Additional Regulation M Exemptions

In addition to investment grade nonconvertible securities, a number of additional activities that occur in the structured note market are exempt from Rule 101:

- publishing and disseminating research materials that are in compliance with Rules 138 and 139 of the Securities Act;
- transactions with QIBs and non-U.S. persons involving Rule 144A securities; and
- participating in unsolicited brokerage transactions or unsolicited purchases not effected from or through a broker or dealer, securities exchange or inter-dealer quotation system, or electronic communications network.

We describe these and other exemptions in more detail in the FAQ referenced above.

New EU Prospectus Regulations: Impact on Structured Notes Offered in the EEA

Background

On July 20, 2017, Regulation (EU) 2017/1129 of the European Parliament and of the Council ("New Prospectus Regulation") came into force in the EEA. When fully implemented, it will repeal the existing Prospectus Directive and introduce a new prospectus regime for prospectuses to be used in an offer of securities to the public and/or admission to

[8] Exchange Act Release No. 34-19565.

trading on a regulated market in the EEA. The vast majority of the provisions of the New Prospectus Regulation will not apply until July 21, 2019 (although certain provisions have applied from July 2017, and others will apply from July 2018).

The aim of the New Prospectus Regulation is to enhance capital flow in the European financial markets by streamlining the prospectus requirements, whilst continuing to ensure investor protection. To that end, changes have been made to the form and content required for prospectuses, and some amendments have been made to the exemptions from certain prospectus requirements in relation to certain categories of offers or issuers.

Impact on Structured Products Transactions

We highlight below some of the key changes that may impact structured securities programs and issuances:

New exemption from obligation to publish a prospectus introduced: Many of the current Prospectus Directive exemptions remain unchanged. However, with effect from July 21, 2018, individual member states may exempt offers of securities to the public in such member state with a total consideration of up to maximum of €8 million (an exemption automatically applies under the New Prospectus Regulation for all offers with a total consideration of less than €1 million in any event). It is not yet clear the extent to which member states will utilize this option.

Prospectus Summaries: A number of significant changes have been made to the requirements for prospectus summaries. From July 21, 2019, issuers will longer be required to include a “pro-forma” summary in a base prospectus. This should help reduce the complexity and length of a base prospectus. However, where applicable, an issue-specific summary will continue to be required for each issue of securities under the base prospectus. It is currently unclear whether a form of the issue-specific summary will need to be included with the form of final terms in the base prospectus. This will hopefully be clarified in the delegated legislation necessary to give effect to the detailed content requirement for prospectuses referred to below.

As is currently the case, there will be an exemption to the summary requirement in respect of an admission to trading of non-equity securities with a minimum denomination of €100,000. This exemption is further extended where the prospectus relates only to an admission to trading of securities that are to be traded only on a regulated market (or specific segment) accessible only by qualified investors.

Although the requirements for summaries under the New Prospectus Regulation will be less prescriptive than under the existing Prospectus Directive, the summary will be subject to new requirements, including that it be written in a concise manner and be no longer than seven sides of A4 paper using characters of a readable size. The summary will be required to have four sections:

- an introduction with a set of warnings;
- key information on the issuer;
- key information on the securities; and
- key information relating to the offer of securities to the public and/or admission to trading.

The summary will also need to include a maximum of 15 key risks that are specific to the relevant issuer and the securities.

Of particular relevance to structured products in the form of securities, the prospectus summary requirements under the New Prospectus Regulation overlap in several respects with the recent EU regulation relating to key information documents for packaged retail and insurance-based investment products (“PRIIPs Regulation”), which applies from January 1, 2018. Where a key information document (“KID”) is required to be prepared under the PRIIPs Regulation for securities offered to the public to which the New Prospectus Regulation will also apply, the “key information on the securities” section in the summary required under the New Prospectus Regulation may substituted with a KID complying with the PRIIPs Regulation.

Risk Factors: The New Prospectus Regulation contains important new provisions relating to risk factors to be included in a prospectus. Risk factors will be required to be limited to risks that are specific to the issuer and/or the securities and that are material in the context of a person making an informed investment decision. The person drawing up the prospectus must assess the materiality of the risk factors based on the probability of their occurrence and the expected negative impact if the risk materializes. The risk factors must also be presented in a specified number of categories depending on their nature, and in each category the most material risk factors shall be listed in order of materiality from high, medium to low, as assessed based on the criteria set out above.

These new provisions relating to risk factors may cause particular difficulties in relation to structured products issuances, particularly in relation to complex products where there may be challenges in ranking the risk factors. As highlighted above, the limit of 15 risk factors in the summary may also be challenging and give rise to liability concerns, as there is always a danger of the determination as to the most material risk factors being judged with the benefit of hindsight where a risk that was judged to be relatively minor at the time of issuance comes to fruition several years later.

Universal Registration Document: Issuers whose securities are admitted to trading on a regulated market or a multilateral trading facility will be able draw up a universal registration document providing certain information about the issuer, which, after being approved by the competent authority of its home member state for two consecutive financial years, may be filed with the competent authority without prior approval in subsequent years. However, where the universal registration document is used as part of a prospectus, any amendments to the universal registration document will need to be supplemented (and approved) in accordance with the New Prospectus Regulation. Therefore, although the initial filing will be "fast tracked" in that no approval is required, it seems that subsequent amendments are still subject to the same level of approval and therefore similar to existing practice.

Detailed Form and Content Requirements: In relation to the detailed requirements for the content of the various elements of a securities prospectus, the New Prospectus Regulation will continue to follow the existing "building blocks" approach with a secondary "tier 2" delegated regulation setting out required information in different annexes that include the information to be included in the registration document and securities note for each issuance. The annexes that are relevant to a particular issuance will depend upon the nature of the security, including whether it is an equity or debt issuance or wholesale or retail debt. There are also specialist annexes for particular types of securities, including derivative securities (which will be relevant to many structured products), convertible and exchangeable securities, and asset-backed securities.

In a Consultation Paper published in July 2017, the European Securities and Market Authority ("ESMA") sets out its draft technical advice to the EU Commission on the format and content of the prospectus under the New Prospectus Regulation. ESMA proposes to largely maintain the existing regime; however, there are some proposed changes aimed at reducing the administrative burden on issuers, including removing the requirement for a report by auditors or independent accountants on profit forecasts. In relation to derivative securities, more detailed disclosure is required for underlying securities and reference obligations and certain disclosures to bring the requirements in line with the EU Benchmark Regulation. Responses on the Consultation Paper can be made up until September 28, 2017, and ESMA has indicated it intends to publish a final report with its recommendations in the first quarter of 2018.

Overall Impact of the New Prospectus Regulation on Structured Products

The New Prospectus Regulation is unlikely to have a major impact on the drafting of prospectuses for structured products issued in the form of transferrable securities; however, issuers of such products will have to make various changes to the form of their existing base prospectuses. Although most of the new requirements will not apply until July 2019, issuers should ensure they make the necessary plans for compliance with the new requirements well in advance of them coming into effect. As mentioned, the rules in relation to the new summary requirements and risk factors may pose particular issues for some structured products.

One other issue that all issuers of relevant securities should have in mind, is the impact of Brexit where securities are offered both in the UK and the rest of the EU. Although the New Prospectus Regulation is currently in force in the UK, July 2019, when most of the provisions come into effect, is likely to be after the effective date of Brexit. It is currently unclear as to whether provisions that only become applicable under the New Prospectus Regulation after the date of Brexit will apply under UK law. Hopefully, this position will become clearer as the Brexit negotiations develop and transitional provisions are finalized. This is, however, an area that issuers of securities will need to keep under careful review.

KIDs and the U.S. Securities Laws

Introduction

As market participants prepare for the effective date of the European Union's "key information document" ("KID") requirements, they must address a variety of drafting and operational issues.[9] In this article, we discuss some of the aspects as to the interplay between the contents of KIDs and the U.S. federal securities laws, particularly where a KID is used in an offering registered under the Securities Act of 1933 (the "Securities Act"). For example, in the context of a U.S. registered offering, there may be sales of a particular structured note to retail investors in the EU, as to whom there is an obligation to deliver a KID. That is, while the offering is principally designed for U.S. investors, the relevant broker-dealers may wish to distribute a portion of the offering to selected European retail investors.

Summary of KID Requirements

In many respects, the contents of a KID will resemble the contents of a summary term sheet prepared for a U.S. registered offering. For example, both types of documents will identify the key terms and the key risks arising from the relevant product.

However, the form and content requirements for the KID are highly prescriptive, including the title headings and order in which information is presented. These requirements mean that a KID would contain a number of significant disclosures that are not currently included in typical U.S. structured note offering documents:

- a summary risk indicator for the product (numbered from 1 (least risky) to 7 (most risky)), supplemented by a narrative explanation of this indicator; and
- a section entitled "How long should I hold it and can I take money out early?", which is designed to indicate the potential consequences (and payments) from selling the product before the end of the term.

We specifically have identified these items, as they potentially raise disclosure issues for offerings regulated by the U.S. securities laws. For example, especially in the context of a short-form document such as a KID (which is not allowed to exceed three pages of A4 paper[10] in length), that provides only limited room for qualifications and explanations, these types of disclosures may, to a U.S. practitioner, seem potentially inadequate or speculative, unless accompanied by a somewhat longer explanation of factors that describe the underlying assumptions and the limitations of the information shown. Put another way, while the disclosures will be required under EU regulations, they may create significant additional liability concerns when used in the context of an SEC-registered offering.

Analyzing a KID Under the SEC Rules

To understand the use of such a document in an SEC-registered offering, we turn to the SEC's rules relating to free writing prospectuses. After all, in one sense, these are offering documents that do not take the form of an SEC statutory prospectus.[11] Because they would be delivered to an investor after the final terms are determined for an offering, they could be considered a "final terms" free writing prospectus, requiring filing via EDGAR within two business days, per Rule 433(d)(1)(i)(C).

Taking such an approach may not be very desirable in the context of a public offering:

- the disclosures in the KID, such as the new ones discussed below, would not (at least under current practice) be provided to U.S. investors in the offering, potentially creating a question as to whether all investors were fairly treated and received the full disclosures;
- the issuer and other parties could be subject to U.S. securities law liabilities for the content of these documents, which differ in some respects from those of typical U.S. offering documents; and
- in the case of "ineligible issuers," some of these disclosures may appear to go beyond the permitted disclosures under Rule 164.

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[9] We discuss the KID requirements in the following issue of this publication, available here.
[10] For the curious reader, who likes numbers and/or footnotes, we would point out that A4 paper measures 210 × 297 millimeters. And for those of you who don't do the metric system, we would mention that corresponds to 8.27 × 11.69 inches.
[11] *See* Rule 405 under the Securities Act.

Potential Approaches

How can participants in U.S. registered offerings address these issues? We discuss in this section a few possibilities that have been considered by market participants.

Adding Disclosures to U.S. Offering Documents. One approach would be to take the new disclosures and add them to the U.S. offering documents for the relevant offerings, such as red herrings. Doing so would ensure that all investors in an offering have comparable access to them before making an investment decision. However, as discussed above, these types of disclosures might be viewed as problematic in the context of a U.S. offering and could expose the issuer and other parties to potential liabilities.

Provide the New Disclosures Solely in the Context of a KID. This approach is the exact opposite to the approach in the prior paragraph. It would mirror the approach that was followed for many years in the context of debt offerings that involved a "Canadian wrapper." In these offerings, relevant Canadian offering rules required the delivery of a variety of disclosures, particularly relating to potential Canadian securities law liabilities and rescission rights, to Canadian investors. The U.S. offering documents would be "wrapped" in the pages for these disclosures, and they would be furnished solely to Canadian investors, without any filings being made in the U.S. under Rule 433 or otherwise, and without delivery to U.S. investors.

From a U.S. securities law perspective, no U.S. disclosures or filings were viewed as necessary for these Canadian documents. They related to jurisdictional matters that (a) were required only under particular Canadian rules, (b) were relevant only to Canadian investors, and (c) would be immaterial to U.S. investors. In the present case, while "a" would be true as to the KID disclosures, it is less clear that "b" and "c" would be the case.

Use Different Program Documents. Of course, most major issuers of structured products in the U.S. have analogous EMTN or similar programs that they use in Europe for offerings intended principally for European investors. These issuers could simultaneously offer securities with substantially identical terms (a) to U.S. investors under their SEC-registered programs, and (b) to European retail investors under their European program. Each offering would conform solely to the rules of the relevant jurisdictions, such that only the European retail investors would receive the disclosures in the KID.

This approach would presumably help an issuer defend the delivery of different "disclosure packages" to different types of investors – each investor would receive solely the disclosures required under the relevant rules and regulatory framework. However, taking this approach would impose the paperwork and administrative burden of preparing a duplicative set of offering documents in connection with the relevant offerings. In addition, some distributors may not know whether there will be European retail purchasers in an offering until relatively late in the offering period. In any event, to the extent additional disclosures and risks about an economically comparable product are set forth in the KID that are not in the U.S. offering documents, an issuer could possibly face claims that U.S. investors were not provided with all of the relevant disclosures.

A Chilling Effect?

U.S. market participants have not yet determined a consistent approach to addressing these issues. If unable to resolve this conundrum in a satisfactory manner, some issuers and product manufacturers may decide that it is easiest to simply avoid selling U.S.-registered structured notes to European retail investors. Of course, if that is the result, it would be another example of financial regulation reducing investor options in the relevant market.

FINRA Fines Broker-Dealers for Sales of Non-Traditional ETFs

In August 2017, FINRA entered into a consent agreement with a Georgia-based broker-dealer arising from improper practices and procedures relating to its sales of leveraged ETFs.[12] The sales included ETFs that were leveraged, inverse, or both inverse and leveraged, and that were sold to retail accounts. The action reflects FINRA's continuing concerns about the procedures that its members have used to approve and monitor sales of these products.[13]

[12] The agreement may be found here.
[13] For example, in FINRA Regulatory Notice 09-31 (2009), FINRA highlighted a variety of its concerns relating to sales of these products, including that they are typically not suitable for retail investors who plan to hold them for more than a single trading session. For example, FINRA has explained that

This action follows a somewhat similar action in June 2017. In the June 2017 proceeding, FINRA determined that a broker-dealer did not perform adequate pre-sale due diligence or post-sale reviews in connection with sales of these types of ETFs, in contravention of its own written supervisory procedures.[14]

Supervisory Procedures and Reasonable Basis Suitability

FINRA determined that the broker-dealer did not establish and maintain a supervisory system, including written procedures, reasonably designed to ensure that its offerings of the ETFs complied with relevant rules. The firm had permitted its representatives to recommend the ETFs without establishing a general supervisory system that was sufficiently tailored to address the unique features and risks involved with these products, in violation of FINRA Rule 2010. The firm did not perform any reasonable basis suitability analysis of these ETFs in order to understand these features and risks before offering them to retail customers. FINRA also found that the broker-dealer and its registered representatives did not fully understand the features and risks of these products, resulting in unsuitable recommendations to customers that had conservative and moderate investment objectives and risk tolerances, including a number of elderly investors, in violation of FINRA's suitability rules, including Rules 2111 and 2010.

In 2009, when publicity increased about the risks of these products, the broker-dealer did not maintain any reasonable supervisory system or written procedures to monitor their recommendations. However, at the end of 2009, following the release of FINRA Notice 09-31, the broker-dealer prohibited the offering of these ETFs that had *more than 2x* leveraged and/or inverse performance of the relevant underlying index and revised its written procedures to address this prohibition. However, the broker-dealer did not revise its procedures to address the risks posed by these ETFs that involved *2x or less* leveraged and/or inverse performance of an underlying index. Accordingly, these recommendations continued.

Similarly, the broker-dealer did not produce exception reports or any alerts in its trade review system that addressed the risks of these ETFs.[15] It did not implement a supervisory system to review the recommendations of the ETFs arising from a customer's age, investment objective, risk tolerance, or financial profile. These failures resulted in recommendations to retail investors for whom they were not suitable.

Extended Holding Periods

FINRA determined that the broker-dealer's general supervisory procedures were insufficient to address the unique features and risks involved with these products, including that their performance over longer periods of time can differ significantly from the performance of their underlying index. Accordingly, for several years, the broker-dealer did not develop any system or procedure to monitor, review, or evaluate the length of their holding periods.

In May 2012, the broker-dealer implemented a monthly report reflecting the holdings of these ETFs in retail customer accounts. However, FINRA determined that the broker-dealer's supervisors did not receive guidance on how to evaluate holding periods or address the risks related to long-term holding periods. As a result, even after these reports were generated, many retail customer accounts held these ETFs for long periods (in some cases, more than 1,000 days).[16] Retail customers holding these ETFs for extended periods of time incurred significant losses.

Accordingly, FINRA determined that the broker-dealer violated, for example, FINRA Rule 2010, due to its failure to establish and maintain a supervisory system, including written procedures, reasonably designed to achieve compliance with applicable rules for the sales of these products.

Sanctions

As a result of these factors, the broker-dealer consented to several sanctions:

- censure;
- a fine of $100,000; and
- restitution to certain customers in the amount of approximately $500,000.

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broker-dealers "must understand the terms and features of the funds, including how they are designed to perform, how they achieve that objective and the impact that market volatility, the ETF's use of leverage, and the customer's intended holding period will have on their performance."

[14] *See Coastal Equities, Inc.* ("*Coastal*"), which may be found here.

[15] Similarly, in *Coastal*, the broker-dealer did not have exception reports relating to these types of ETFs and did not implement a system to monitor their holding periods and losses.

[16] In addition, there was a 15-month period in which the broker-dealer ceased to produce these holding reports due to technical issues.

Our Take

FINRA's notices have made clear that it intends to carefully scrutinize broker-dealer procedures when complex securities are sold, particularly when they result in losses to vulnerable investors. Broker-dealers are strongly encouraged to periodically review their written supervisory procedures to ensure that they reflect the products that are being offered and FINRA's guidance.

In particular, broker-dealers, before offering complex products to retail customers, should be able to demonstrate that they conducted an adequate reasonable basis suitability analysis and trained their registered representatives as to their features and risks. Some products, such as the ETFs in question, are not designed to be held for significant periods of time; monitoring systems must be appropriately tailored to monitor the holding periods for these products and to determine whether they are consistent with firm recommendations.

NASAA Survey Finds Seniors Are Most Vulnerable to Financial Fraud

On August 21, 2017, the North American Securities Administrators Association ("NASAA") released a survey on senior citizens and financial exploitation. The survey of the state securities regulators highlighted, among other things, the need for the securities regulators to take a stronger role in prevention and detection.

The survey was conducted internally among NASAA's membership of 67 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico, between July 24, 2017 and August 4, 2017. 36 regulators from NASAA member organizations responded. A summary of the findings is below:

- There is greater awareness of the investment fraud or exploitation risks seniors face now than there was a year ago.
- In the past year, there has not been a decrease in cases or complaints involving senior financial fraud or exploitation.
- Agencies that reported an increase in cases or complaints involving senior financial fraud or exploitation have taken steps to diminish fraud, including investor education and senior outreach, adopting the NASAA Model Act to Protect Vulnerable Adults from Financial Exploitation, enforcement, etc. In fact, 52% of the surveyed jurisdictions have adopted legislation/regulation based on NASAA's Model Act to Protect Vulnerable Adults from Financial Exploitation.
- Despite adopting legislation/regulation, the majority of agencies continue to receive reports of suspected senior financial fraud or exploitation.
- 77% of respondents have been successful in using disbursement holds to stop exploitation.
- Most cases of senior financial fraud or exploitation go undetected until it is too late.
- 75% of respondents believe that broker-dealers and investment advisers are not doing enough to prevent senior fraud.
- 82% of respondents believe the "silent generation" is the most vulnerable to financial fraud.

A copy of the NASAA survey is available here.

Both the SEC and FINRA have stressed the importance of protecting elderly investors from financial exploitation, and have noted that the problem is only expected to grow as our population ages. A summary of FINRA's activities and guidance relating to senior investors may be found here. In 2017, FINRA issued Regulatory Notice 17-11, and announced that it had received SEC approval on a rule proposal addressing the financial exploitation of seniors. The rule proposal, which becomes effective in February 2018, involves a two-step approach to protecting investors: (1) firms will be required to make reasonable efforts to obtain the name and contact information for a trusted contact person for a customer's account and (2) firms will be permitted to place a temporary hold on a disbursement of funds or securities when there is reasonable belief of financial exploitation.[1] In addition, both FINRA and the SEC's Office of Compliance Inspections and Examinations have identified this area as one of their examination priorities.

Our Take

The survey is yet another indication that many regulators are quite keen to take steps to help root out the financial exploitation of seniors. Broker-dealers can expect a continuing regulatory focus on the steps that they are taking to prevent this form of exploitation, and potentially, additional regulatory action in the future at the state level, in addition to FINRA's continuing attention.

Changes to S&P and Russell Index Methodologies

As many readers of this publication know, in late July 2017, each of S&P Dow Jones Indices ("S&P") and FTSE Russell announced changes to their index methodologies relating to companies with multiple share class structures. These changes followed consultation results that were published earlier this year.

Effective July 31, 2017, the S&P Composite 1500 and its component indices (the S&P 500, S&P MidCap 400, and S&P SmallCap 600) will no longer include companies with multiple share class structures, such as Snap Inc. and Blue Apron Holdings, Inc. Existing constituents of the indices, including Facebook, Inc. and Alphabet, Inc. (Google), will be grandfathered in and will not be affected by the methodology change.

Effective at the September 2017 quarterly and semi-annual index reviews, FTSE Russell announced changes to the methodology of all FTSE Russell indices, requiring developed-market constituents to have greater than 5% of the company's voting rights held by unrestricted (free-float) shareholders. Companies with less than 5% ownership will be ineligible for index inclusion. The rule will apply with effect from September 2022, affording a five-year grandfathering period to allow current consistent companies to change their capital structures to comply with the revised requirements.

These changes reflect the criticisms of those market participants and observers who are opposed to the limitations that these type of equity structures place on the influence of public shareholders. However, to the extent that these indices are designed to represent in part the securities of recent IPOs that qualify for inclusion, these indices will cease to account for these types of companies. In this respect, these indices will not necessarily be fully representative of the market segments that they were initially designed to track. The structured notes and structured CDs will similarly cease to have exposure to these types of companies.

Upcoming Event

Structured Products Washington D.C. Conference 2017
Wednesday, October 4, 2017
Morrison & Foerster Sponsorship

Hyatt Regency Washington on Capitol Hill
400 New Jersey Ave NW
Washington, DC 20001

The 5th annual Structured Products Washington D.C. conference will be returning to the capital on October 4, with the program showcasing the latest developments in the legal, regulatory, and compliance landscape for structured products. Click here to register.

***GlobalCapital* has named us Global Law Firm of the Year at their 2017 Global Derivatives Awards for the second year in a row**.

For the third year in a row, *GlobalCapital* named us the Americas Law Firm of the Year at their 2017 Americas Derivatives Awards.

We were again been named Best Law Firm in the Americas by StructuredRetailProducts.com at the 2017 StructuredRetailProducts and Euromoney Americas Wealth Management and Derivatives Conference.

When it comes to advising financial institutions, whether it's bank regulatory advice, debt or equity offerings, derivatives, securitization, or structured products, Morrison & Foerster leads the way.

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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.

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

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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 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.