Morrison & Foerster News Bulletin Volume 8, Issue 1 January 24, 2017

Structured Thoughts

News for the financial services community.

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U.S. Court of Appeals Upholds SEC's Backtesting Finding

In a 2016 case before the U.S. Court of Appeals for the D.C. Circuit, a former investment adviser lost a petition to review and vacate the decision of an SEC administrative law judge relating to the improper use of backtested information. The case was mainly followed by market participants who are following the challenges to the SEC's use of administrative law judges to handle disciplinary cases and other alleged violations of the federal securities laws. However, the case is also an illustration of how the improper presentation of backtested information can lead to trouble under the SEC's rules and regulations.

The Court of Appeals' decision may be found at: *Raymond J. Lucia Cos. v. SEC*, 832 F.3d 277 (DC Cir 1986).

The SEC's September 2015 opinion discussed by the appellate court may be found at the following link: https://www.sec.gov/litigation/opinions/2015/34-75837.pdf

At issue in the case were presentations of "backtested" historical performance for an investment strategy entitled "Buckets of Money," which, among other things, involved the shifting of assets between different investment types under various market conditions.

The SEC determined that investors who received the presentations were misled by statements that the investment strategy was "backtested." The presentations were based on a combination of historical data, together with assumptions about the rate of inflation and the rate of return on REITS, which were one type of strategy on which the strategy was based.

The presentations indicated that the strategy would have been effective during periods of market volatility, but did not indicate that the presentations were in fact showing "abstract hypotheticals," without indicating that significant

assumptions were made. The presentations were also misleading in that they did not implement a key part of the strategy: moving assets from the riskiest buckets of assets to safer buckets of assets.

According to the SEC, the presentations were misleading in that they represented that the use of the investment strategy would have shown the value of investments increasing, even though they were based on flawed assumptions: underestimating the effect of inflation and the expected REIT returns, thereby dramatically departing from historical reality. The failure to move assets from one class to another resulted in the presentation figures being based on an artificially high percentage of assets in stocks during the time when stock market values were increasing. In fact, had the presentation used more realistic estimates, and shifted the assets as the investment strategy actually contemplated, the strategy would have run out of assets, as opposed to increasing in value.

The SEC did not agree with the advisors claims that the term "backtest" did not necessarily relate to a presentation that was based solely on historical data. While certain presentation slides did include cautionary language, the slides did not provide any indication to investors as to the extent to which the results that were presented in fact differed substantially from how the strategy was supposed to perform in practice and what its actual results would have been had that strategy been followed.

In this particular case, the SEC found a fairly reckless pattern of behavior in presenting the relevant information. In creating information of this kind, particularly for use in securities offering documents, most of today's market participants exercise a fairly high degree of caution and a careful degree of review. In presenting this type of information, it is critical to understand and accurately present the manner in which any departures from actual historic asset performance might be occurring or if any departures are being made from the relevant strategy or index rules. And of course, if it is actually impossible or impracticable to set forth how a strategy or index would have actually performed using actual historical values and the actual rules, it may be appropriate to consider whether that information should be used at all in selling an investment product.

The Department of Labor's Fiduciary Rules: Potential Revisions to MSDA Forms

In connection with the Department of Labor's (the "DOL") new rules relating to fiduciary duties,[1] we have received a variety of inquiries from broker-dealers and other parties relating to the distribution of structured products. These rules will become effective in April 2017, in the absence of any further regulatory or Congressional action. Accordingly, many of these entities are seeking to adjust their MSDAs and similar sales or distribution agreements in order to clarify that they, or their counterparties, as applicable, are acting on a "riskless principal" or an "agency" basis, with a view to complying with the new BIC Exemption. (As readers of this publication know, the new BIC Exemption is not designed for use with purchases and resales made on a principal basis.)

For this purpose, we have prepared the form of MSDA addendum agreement set forth below. We have attempted to set forth this agreement in a format that will work well with a variety of MSDA forms that are currently in use. However, depending upon the agreement that is being amended, additional revisions may be needed.

The form agreement below includes several italicized notes for clarification. In addition, the capitalized terms in the document should of course be reviewed for consistency against those in the existing agreement.

In connection with these updates, the parties may wish to review all of the provisions of the related agreement, to see if any improvements are needed or desirable or to ensure that the provisions are consistent with the business arrangements between the parties. As time passes, a variety of revisions based on evolving market practice, or changes in applicable laws and regulations over the past several years, may be worthy of consideration.

[1] For additional discussion, please see our article, "Implications of the DOL Fiduciary Rule for Structured Products," at the following link: https://media2.mofo.com/documents/160504structuredthoughts.pdf. For an additional discussion of "riskless principal transactions," please see our November 17, 2016 issue of this publication, which may be found at the following link: https://media2.mofo.com/documents/161116-structured-thoughts.pdf.

Supplemental Letter Agreement to [Master Selected Dealer Agreement]
[note: name of agreement may be revised as needed]
Relating to Riskless Principal and Agency Transactions

Dated as of ____, 20__.

Reference is made to that certain [Master Selected Dealer Agreement], dated _____, 20__ (the "Agreement"), into which you and we have previously entered. Unless otherwise defined herein, capitalized terms used herein have the meaning specified in the Agreement. We hereby agree with you to amend the Agreement on the terms set forth herein. The Agreement shall remain in full force and effect, except as modified hereby.

1. Your Purchases of the Securities. Notwithstanding any provision to the contrary in the Agreement, if you are purchasing any Securities under the Agreement, you shall purchase them in "riskless principal transactions," which in some cases will be resold to "Retirement Investors" (as such terms are defined in 29 C.F.R. 2550) and/or to other customers as to which you owe a fiduciary duty under applicable U.S. laws or regulations (each such purchaser, a "Fiduciary Customer"). *[Note: the prior language is designed to address both the DOL rules and any comparable future rules that are issued by the SEC relating to fiduciary duties. If desired, the provision may be modified to be limited solely to retirement accounts under the DOL rules.]* If at any time you determine that any of the Securities that you have sought to purchase from us in such a transaction will not be purchased by the applicable Fiduciary Customer on the applicable settlement date, whether due to a failure to settle by such Fiduciary Customer or other factors, you will advise us in writing as promptly as possible. We will use our reasonable efforts to cancel our own planned transaction in such Securities, and if we succeed, we will advise you in writing, in which case you will have no obligation to purchase the applicable Securities.

2. Acting as Agent. Notwithstanding the provision of paragraph 1 above, and for the avoidance of doubt, you may continue to act in the capacity of an agent, as contemplated by the Agreement, if you are not purchasing the Securities on a riskless principal basis. *[Note: this provision contemplates that the existing agreement already includes the possibility of transactions on an agency basis, as many or most existing forms do. If the existing agreement does not contemplate the possibility of sales on an agency basis, additional changes may be needed.]*

3. Compliance with Law. Section ___ of the Agreement shall be amended and restated as follows: "You agree that in selling Securities pursuant to any Offering (which agreement shall also be for the benefit of the Issuer or other seller of such Securities) you will comply with all applicable laws, rules and regulations, including the applicable provisions of the Securities Act and the Exchange Act, the applicable rules and regulations of the Commission thereunder, the applicable rules and regulations of any securities exchange having jurisdiction over the Offering, the applicable rules of the U.S. Department of Labor, and the applicable rules and regulations of any regulatory organization having jurisdiction over your activities. You represent and warrant, on behalf of yourself and any subsidiary, affiliate, or agent to be used by you in the context of this Agreement, that you and they have not relied upon advice from us, any Issuer of the Securities, the Underwriters or other sellers of the Securities or any of our or their respective affiliates regarding the suitability of the Securities for any investor." *[Note: the key point of this*

paragraph is simply to add the reference to the DOL, because dealers will be subject to these rules in connection with many sales. The language of this provision may be revised as needed to be consistent with the provisions of the applicable existing agreement.]

4. Governing Law. This letter agreement shall be governed by, and construed in accordance with, the laws of the [State of New York].

Please confirm by signing and returning to us the enclosed copy of this letter agreement.

[UNDERWRITER NAME]

By:_____
Name:
Title:

CONFIRMED: _____, 20__

[DEALER NAME]

By:_____

Name:_____
(Print name)

Title:_____

Structured Product Offerings: A Framework for Post-Approval Review

FINRA has previously noted that it expects broker-dealers to conduct a post-approval review for offerings of new products, including retail structured notes. This review is typically conducted by a broker-dealer's "new product committee" or similar body. For example, FINRA Notice 05-26 states that broker-dealers should:

- track and monitor customer complaints and grievances relating to new products;
- reassess the firm's training needs regarding a product on a continuing basis;
- establish procedures to monitor, on an ongoing basis, firm-wide compliance with any terms or conditions that have been placed on the sale of the product;
- periodically reassess the suitability of the product; and
- review any product before lifting any restrictions or conditions on the sale of the product.

Similarly, FINRA Notice 12-03 states that a "well-designed system of internal controls should include a process to periodically reassess complex products a firm offers to determine whether their performance and risk profile remain consistent with the manner in which the firm is selling them."

More recently, FINRA's 2013 Report Relating to Conflicts of Interest states that an "effective practice for product manufacturing firms is to implement post-launch reviews to identify potential issues with a product that may not have been apparent during the initial review process, which could lead to conflicts of interest or reputational risk. Such issues could include unexpected product performance, subsequent activity by the manufacturer that may specifically influence the performance of the product, use by investors for whom the product was not intended, or use that is inappropriate or unanticipated."

In this article, with these principles in mind, we provide a sample framework and checklist for conducting this post-approval review. Each relevant broker-dealer will of course need to consider its processes in light of its own business model, including the nature of its investor base, and the types of products that it sells. In addition, if a broker-dealer sells any of its products outside of the United States, the laws and practices of the relevant jurisdictions may need to be considered.

Selection Process for Review

The broker-dealer may consider selecting notes for review:

- By underlying reference asset to ensure a variety of reference asset exposures are considered;
- By date (i.e., some issued in first quarter of the most recent year, some issued in third quarter);
- By pay-off feature (principal-protected, buffered, etc.), with an emphasis on the most complex structures;
- By distribution channel; based on sales volumes, retail focus of distributor, or other relevant criteria; or
- Any other reasonable sampling basis.

Proposed Procedures for Post-Approval Review

The new product committee should be provided with data, including:

- Amounts offered,
- Distribution channel,
- Types of investors,
- Product performance,
- Any distributor or investor complaints or inquiries,

- Any inquiries received from regulators on the product type, marketing materials used, offering documents used, and the initial new product committee approval submission.

The committee may wish to consider the extent to which:

- The product is described appropriately in marketing and disclosure documents, particularly as to the disclosure of the relevant risk factors;
- Whether the product description in the original new product committee submission remains accurate;
- Whether the product has performed as contemplated at the time of approval;
- Whether any additional training of representatives or distributors is advisable;
- Whether the performance is consistent with any relevant hypothetical back-tested data and/or any sensitivity or similar tests;
- Whether the objective of the products remains valid or addresses a market need;
- Whether investors have attempted to liquidate the product prior to maturity to a greater extent than other products;
- Whether any operational issues have arisen;
- Any compliance issues that have arisen, including any unexpected conflicts of interest;
- Whether peer firms are offering similar products;
- Whether any other products are offered that are advantageous as compared to the relevant product, for example, with fewer fees, greater liquidity, etc.;
- Whether the distribution channel should be changed, minimum purchase amounts required, or other precautions taken.

OCIE and FINRA Announce Exam Priorities for 2017

In January 2017, each of the SEC's Office of Compliance Inspections and Examinations ("OCIE") and FINRA issued their broker-dealer exam priorities for 2017.

Neither regulator specifically mentioned structured products as an area of focus in 2017. However, industry participants need to be mindful of a variety of issues that were raised, and certainly closely relate to challenges faced in the structured products world during the past several years, including FINRA's suitability requirements (including as to new and complex products), sales to elderly investors, and investment advisors who operate from branch offices.

Our client alerts discussing these priorities can be found at the following links:

- OCIE: https://media2.mofo.com/documents/170112-ocie.pdf
- FINRA: http://www.bdiaregulator.com/2017/01/finra-issues-2017-examination-priorities-letter/

DTC's MMI System Ends Processing of Physical Delivery Option Securities

As many issuers know, securities that have an option to be redeemable for equity or other securities at maturity ("stock at maturity securities") are ineligible for The Depository Trust Company's DTC Money Market Instrument ("MMI") system.[2] Since April 20, 2015, the DTC MMI system stopped accepting these securities. As an accommodation to issuers of stock at maturity securities existing in the DTC MMI system prior to April 20, 2015, DTC previously announced that it will process the delivery of securities, rather than cash, at maturity, for a "Non-Standard Corporate Actions Fee" of $5,000 per CUSIP if DTC is notified of the non-cash settlement no later than the second business day prior to the maturity date. The processing fee is $7,500 if DTC is notified of the non-cash settlement less than two business days prior to the maturity date.

As a reminder to our readers, effective April 1, 2017, DTC will not process any non-cash settlements of stock at maturity securities in the DTC MMI system.

A representative of DTC confirmed to us that if an issuer has a stock at maturity security currently in the DTC MMI system and opts for a cash settlement at maturity, DTC MMI will support the cash settlement. In that situation, the issuing and paying agent should contact DTC prior to the maturity date to confirm that the issuance will settle in cash.

In order to address these developments, issuers of stock at maturity securities should ensure that they assign a corporate bond CUSIP number, rather than a MMI CUSIP number, to these products.

DOL: Additional Guidance on Fiduciary Rule

On January 13, 2017, the U.S. Department of Labor ("DOL") issued a second set of guidance on its new fiduciary rules. The DOL published this information in the form of FAQs ("FAQs"), and this is the second round of guidance published by the DOL prior to the effective dates of the new rules.[3]

The FAQs cover a variety of topics, including a discussion of the "seller's exception," and how a broker-dealer can establish that its purchaser has appropriate qualifications. For our full discussion of these FAQs, please see our client alert, which may be accessed from the following link: https://media2.mofo.com/documents/170123-dol-fiduciary-rule.pdf.

The rules are currently scheduled to become effective on April 10, 2017. However, as readers of this publication know, there is significant conjecture in the marketplace as to what action, if any, the new U.S. administration may take that may impact its implementation, or the timing of effectiveness.

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 email Carlos Juarez at cjuarez@mofo.com.

[2] See DTC Notice 0631-15 (Apr. 8, 2015).
[3] https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-2.pdf

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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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