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Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Implementing the DOL Fiduciary Rule

Background

On June 9, 2017, key provisions of the fiduciary rule adopted by the Department of Labor ("DOL") will become applicable for most broker-dealers, as well as many bankers, insurance agents, and others who make investment recommendations to retail retirement investors (the "Fiduciary Rule"). As discussed below, only a portion of the Fiduciary Rule and related exemptions become applicable on June 9. The DOL is conducting a re-evaluation of the Fiduciary Rule and related exemptions, as directed by President Trump. Many expect substantial changes to result from this re-evaluation, although it is impossible to predict the ultimate outcome. In the meantime, during the transition period starting on June 9, 2017, and expected to continue until at least January 1, 2018 (the "Transition Period"), broker-dealers and others must comply with those provisions that become operative on June 9.

What happens on June 9?

Starting on June 9, you will be deemed a "fiduciary" if, for compensation, you provide advice or recommendations to a retail retirement investor[1] about investments, investment strategies, investment managers, or investment account arrangements.[2] This will be true even if you don't have discretionary authority over the account and even if the advice is episodic and not part of an ongoing relationship.

[1] "Institutional" retirement accounts managed by banks, investment managers, broker-dealers, insurance companies, and other fiduciaries with at least $50 million under management should generally be exempt from the requirements of the Fiduciary Rule.
[2] General educational materials would not be deemed the type of advice that would trigger the fiduciary duty.

What are the responsibilities of a fiduciary?

Generally speaking, fiduciaries are required to act in the best interest of the persons to whom they owe a fiduciary duty. They owe a duty of undivided loyalty to those persons, and they must exercise the care and skill that a prudent person would use in like circumstances. Absent an available exemption, ERISA generally prohibits fiduciaries from acting as principals[3] and from receiving commissions or other forms of variable compensation when dealing with retail retirement accounts to whom they owe a fiduciary duty.

Are there available exemptions that would permit me as a fiduciary to receive commissions or act as a principal?

Also becoming applicable on June 9, 2017, are two new prohibited transaction exemptions adopted by the DOL: the Best Interest Contract Exemption ("BIC Exemption") and the Principal Transactions Exemption ("Principal Transactions Exemption"). Both the BIC Exemption and the Principal Transactions Exemption contain extensive requirements for compliance. However, most of the conditions set forth in these new exemptions will not become applicable on June 9. Rather, during the Transition Period, fiduciaries need only comply with the impartial conduct standards described in the exemptions (the "Impartial Conduct Standards"). By complying with the Impartial Conduct Standards, fiduciaries may use the BIC Exemption during the Transition Period to receive commissions or other forms of variable compensation for transactions effected on an agency or riskless principal basis.[4] By complying with the Impartial Conduct Standards, fiduciaries may use the Principal Transactions Exemption during the Transition Period to sell investment products to retail retirement accounts on a principal basis, provided that the transaction involves financial instruments that are within the limited scope of the Principal Transactions Exemption.[5]

What are the Impartial Conduct Standards?

The Impartial Conduct Standards require fiduciaries to:

- Act in the "best interest" of the client.
- Charge only reasonable compensation.
- Avoid any misleading disclosures regarding investment products and fees and any material conflicts of interest that might affect the fiduciary.

Does compliance with FINRA suitability requirements satisfy my obligation to act in the best interest of the client?

Not necessarily. The best interest standard is a rigorous standard that requires the fiduciary to recommend investment products that are in the "best interest" of the client without regard to the financial interests of the fiduciary. While a range of investment products may be "suitable" for an investor, only a subset of the suitable products may meet the best interest standard. The guidance issued by FINRA in Regulatory Notice 12-25 narrows the gap between "suitability" and "best interest" by providing that recommendations must be "consistent" with a customer's "best interests." However, in adopting the Fiduciary Rule, the DOL declined to rely on the FINRA suitability standard, observing that the DOL requires fiduciaries to make investment recommendations that are guided solely by what is best for the retirement investor. To meet this standard, a fiduciary should conduct thorough diligence on all investment products, comparing product features and fees with comparable products in order to evaluate which products are in the best interest of the client. The basis of this conclusion should be documented.

What else should I do to meet the Impartial Conduct Standards?

In addition to thorough product diligence, fiduciaries relying on the Impartial Conduct Standards should:

- Train sales personnel and supervisors to understand the differences between a "suitability" standard and a "best interest" standard.

[3] Under the Investment Advisers Act of 1940, investment advisers (who are subject to a fiduciary duty) may not enter into principal transactions with their clients absent full disclosure and client consent on a transaction-by-transaction basis, subject to an opt-out right.
[4] The BIC Exemption is not available for transactions in which the fiduciary is acting on a principal basis, including transactions effected for the account of an affiliate.
[5] The Principal Transactions Exemption only covers Government and agency securities, CDs, UITs, and certain debt securities issued by U.S. companies in registered offerings. The exemption is not available to underwriters.

- Meet with their retail retirement investors on a regular basis, seeking an adequate understanding of the client's current circumstances and objectives.
- Evaluate the reasonableness of all compensation received by the firm for each investment product.
- Evaluate internal compensation arrangements and revise if necessary to ensure that they do not improperly incentivize sales personnel to recommend products that are not in the best interest of retail retirement investors.
- Monitor account activity with a view to detecting potential deviations from the new best interest standard.
- Be certain to provide full and timely disclosure of material conflicts of interest.

As our readers know, many market participants commenced these processes at the time the DOL first announced its final rules.

May I sell proprietary products during the Transition Period?

Yes, but you should proceed with caution. The BIC Exemption and guidance from the DOL contemplate that proprietary products may be sold. However, the inherent conflicts of interest associated with proprietary products pose a challenge under the best interest standard. A broker-dealer seeking to sell proprietary products to a retail retirement account should be certain that (i) the product compares favorably in terms of benefits and costs with competing products and (ii) the financial benefits to the firm, its affiliates, and its representatives are not incentivizing the selection of proprietary products over other products that would be better for the client.

Documentation of this analysis is particularly important for proprietary products. In addition, timely disclosure should be made of the potential conflicts of interest relating to the recommendation of a proprietary product.

What are my obligations if I only charge a fee based on the value of assets in the account?

Broker-dealers or others who charge a fee based on assets under management or a similar standard are deemed "level fee fiduciaries." Their fee arrangements are permissible under ERISA, and they are generally not required to comply with an exemption. However, they are fiduciaries and, while not technically subject to the Impartial Conduct Standards, they are expected to act in the best interest of their clients and to avoid any unreasonable compensation.

Level fee fiduciaries may not receive any kind of transaction-based compensation, nor may they effect transactions on a principal basis with accounts that they service on a level-fee basis.

In addition, level fee fiduciaries advising clients on rollovers or other changes in the status of accounts will need to comply with the BIC Exemption, given the possibility that such advice may result in higher fees for the fiduciary. Therefore, level fee fiduciaries should carefully analyze a client's options before making any recommendations on rollovers or similar actions and be certain to document the rationale for their recommendations.

What happens if I make mistakes during the Transition Period?

The DOL and the IRS have both indicated that they intend to focus on compliance assistance, rather than enforcement actions, during the Transition Period. In this regard, the DOL has noted the difficulty of adjusting long-standing business practices to the new requirements. The DOL is also aware of the variety of interpretative questions that have arisen under the rules.

While this approach is welcome, there are two important caveats. First, the DOL position is premised on the fiduciary making good faith efforts to comply with the Fiduciary Rule. Firms that ignore the requirements or are cavalier about their compliance efforts may be subjected to enforcement actions. Secondly, the DOL position is not binding on private parties. As pointed out by many commentators, broker-dealers who become fiduciaries on June 9 will be potentially vulnerable to customer complaints alleging breach of their fiduciary responsibilities.

This article first appeared on MoFo's BD/IA Regulator blog.

Living with the DOL Fiduciary Rule: Be Prepared for the June 9 Implementation Date

To date, the Fiduciary Rule has survived all challenges. In response to an executive order issued by the President directing the DOL to re-evaluate the rule, the DOL postponed implementation of the more complex provisions of the BIC Exemption and the Principal Transactions Exemption until January 1, 2018, in order to afford the DOL more time to conduct the mandated re-evaluation. However, certain provisions were only delayed for 60 days and are scheduled to be implemented on June 9, 2017.

On May 22, 2017, the DOL announced it did not intend to seek any further delays of the June 9 implementation date. With less than three weeks to go before June 9, it appears unlikely that the initial phase of the Fiduciary Rule will be derailed. For those market participants who have not yet prepared for implementation, the time has come to act.

Read our client alert.

SEC Registration of Structured UITs

Unit investment trusts ("UITs") with payoff structures similar to those usually associated with structured notes are beginning to gain appeal. These UITs are a departure from the traditional UIT asset classes (i.e., tax-exempt municipal bonds, taxable debt, or equities) in that the structured UIT's portfolio may consist of, for example, exchange-traded options, U.S. treasury obligations, and/or cash or cash equivalents, and the payoff will be obtained by referencing the performance of a traditional structured notes underlying reference asset, such as an exchange-traded fund.[6]

For those of us accustomed to the expedited registration and shelf takedown process available to well-known seasoned issuers ("WKSIs"), which include most structured note issuers, the registration process for UITs may be unfamiliar. In fact, the process may seem like a throwback to pre-2005, or pre-Rule 415, practice. This article summarizes the registration process for UITs and some of the differences between structured notes and structured UITs as they relate to SEC registration.

Dual Registration

Units of a UIT must be offered and sold pursuant to a registration statement on Form S-6 deemed effective by the Securities and Exchange Commission (the "SEC") under the Securities Act of 1933 (the "Securities Act"). The UIT also is an investment company subject to registration under the Investment Company Act of 1940 (the "Investment Company Act"). As a result, it must also register with the SEC on Form N-8B-2. Form S-6 filings are subject to review by the SEC's Division of Corporation Finance, and Form N-8B-2 filings are subject to review by the Division of Investment Management.

If the UIT is organized as a series trust, each subsequent series of that UIT must also register separately on a registration statement on Form S-6. The advantage of the series trust structure is that a single trust can issue multiple series. If a separate trust is created for each offering, each new trust would have to be organized under the relevant state law (generally, New York or Delaware) and register on a Form N-8B-2.

Subsequent Offerings

Although there is no Rule 415 shelf registration process for UITs, Rule 487 under the Securities Act does afford some flexibility for the offering of subsequent series on an expedited basis. To avail itself of the rule, the initial series of a UIT must be offered pursuant to a registration statement on Form S-6 that is subject to review by the SEC. Rule 487 then permits the Form S-6 registration statement relating to a subsequent series of that UIT to become effective automatically without an SEC review period if the new series of the UIT satisfies a number of conditions:

- The UIT must identify one or more prior series that the SEC has declared effective;
- The UIT must represent that the securities deposited in the new series being registered do not differ materially in type or in quality from those deposited in the prior series, and the disclosure in the

[6] An example can be found here.

prospectus for the series being registered may not differ materially from the disclosure in the prior series' registration statement; and

- The UIT must deliver a preliminary prospectus in compliance with Rule 460 (delivery to underwriters).

The SEC limits the availability of Rule 487 for subsequent series. For example, Rule 487 was not available for a UIT with a buffered, leveraged and capped payoff structure linked to the performance of the iShares® Russell 2000 ETF (IWM), when the precedent series was linked to the performance of the SPDR® S&P 500® ETF (SPY). The SEC's rationale was that, because the underlying index was different and there would be different risk factors, the subsequent series would be materially different from the initial filing.

A Rule 487 S-6 is generally just three pages long – a facing page, identification of a prospectus for a previously effective series that will be used as the preliminary prospectus for the current series, and the signature page and exhibit list.

It is good practice to check with your examiner prior to relying on Rule 487.

Naming Conventions

The title of a structured note always includes the name of the underlying reference asset; in fact, not doing so might be considered misleading. If a UIT, however, uses a name that suggests an investment focus, the UIT must devote at least 80% of its assets to that area of focus. Consequently, if the portfolio of a UIT series with a structured payoff consists of exchange-traded options, U.S. treasury obligations, and/or cash or cash equivalents but the payoff of that UIT series is linked to the performance of the SPY, the UIT cannot use the name "SPDR® S&P 500® ETF" in its name because 80% of the UIT's assets are not invested in the SPY.

To learn more, see our Frequently Asked Questions about UITs here.

Section 871(m) Regulations: Changes Made by January 2017 Guidance

Section 871(m) is the Internal Revenue Code provision that treats "dividend equivalents" paid under certain contracts as dividends from sources within the Unites States and therefore subject to U.S. withholding tax if paid to a non-U.S. person. In September 2015, the IRS issued final regulations (the "2015 Final Regulations"). In December 2016, the IRS released Notice 2016-76, which announced that the IRS intended to issue additional final regulations. On January 19, 2017, the IRS released new final regulations, temporary regulations (together, the "Final Regulations"), and proposed regulations covering section 871(m) of the Code and related withholding rules. Despite some initial uncertainty, taxpayers are now treating the Final Regulations as effective. The final and temporary regulations provide technical corrections to the 2015 Final Regulations, but otherwise generally adopt the 2015 Proposed Regulations.

For a full discussion of the highlights of the New Regulations, together with several significant observations, please see our May 2017 issue of *Tax Talk*, which may be accessed here.

IRS Attacking Basket Option Strategies

Basket contracts are generally derivative instruments linked to a basket of reference assets that, among other things, allow the holder to vary the basket over the instrument's life. According to the IRS, these types of contracts have the potential for tax avoidance because taxpayers account for gain or loss on the contract once the contract terminates instead of when changes to the underlying assets are made. The IRS has had basket transactions on its radar since 2015, when the IRS first issued notices classifying basket option contracts as "listed transactions" and basket contracts as "transactions of interest."[7] On February 6, 2017, the IRS issued audit guidelines for auditing basket transactions,[8] in tandem with an earlier announcement of a compliance campaign focusing on such transactions. Now, with the addition of

[7] In October 2015, the IRS issued Notice 2015-73 and Notice 2015-74, which revoked Notice 2015-47 and Notice 2015-48, respectively, and replaced them with new guidance on basket transactions. For a more detailed discussion of Notice 2015-73 and Notice 2015-74, see Vol. 8 Issue 3 of Tax Talk, available here.
[8] The IRS audit instructions are available here.

new audit guidelines, the IRS seems to be intensifying its scrutiny of basket transactions, and taxpayers who have engaged in these transactions would be prudent to prepare for some kind of audit.

Impact of T+2 Change on Existing Tax Rulings

On March 22, 2017, the SEC adopted an amendment to its rules under the Securities Exchange Act of 1934 that shortens the standard settlement cycle for most broker-dealer transactions from three business days after the trade date ("T+3") to two business days after the trade date ("T+2") beginning September 5, 2017.[9] Some older IRS Revenue Rulings and Private Letter rulings consider the difference between the trade date and the settlement date for making determinations such as when gain or loss is recognized on a short sale and the holding period of stock traded on an established securities market.[10] Perhaps it is time for clarification on those rulings that they now apply to the T+2 settlement cycle. However, given the general freeze on IRS guidance,[11] that may not be likely.

Proposed EMIR II – Key Points for Derivatives Markets Participants

On May 4, 2017, the European Commission announced its proposals to amend the current European Market Infrastructure Regulation ("EMIR"). The proposals stem from its public consultation and Call for Evidence, which were carried out in 2015 and 2016 (the "EMIR Review").

The proposed changes will now be considered by the European Parliament and the Council of the EU; however, if they are enacted in their current proposed form, they will affect not only European counterparties, but also many non-EU counterparties.

Although not related to the EMIR Review, the Commission also chose May 4, 2017, to publish a Communication addressed to the European Parliament, the Council of the EU, and the European Central Bank.

The Communication sets out the Commission's intention to introduce, in June 2017, legislative proposals aimed at ensuring "financial stability and the safety and soundness of central clearing counterparties (CCPs) that are of systemic relevance for financial markets across the EU." Essentially, these proposals will provide for "enhanced supervision" at EU level of non-EU CCPs and/or location requirements for those CCPs. Many commentators regard this as an attempted "land-grab" by the EU of the business of clearing euro-denominated derivatives, and the Commission notes that 75% of euro-denominated interest rate derivatives are currently cleared in the UK (which has notified its intention to leave the EU).

Please see our client alert for a more detailed discussion of these proposals, including:

- the classification of counterparties;
- reporting requirements;
- the scope of the clearing obligation;
- required access to clearing;
- margin rules; and
- the applicability to pension funds.

[9] See the discussion in a recent issue of *Structured Thoughts* here.
[10] *See*, *e.g*., Rev. Rul. 2002-44, 2002-28 I.R.B. 84 (2002); Rev. Rul. 93-84, 1993-2 C.B. 225 (1993); and Rev. Rul. 66-97, 1966-1 C.B. 190 (1996).
[11] On January 20, 2017, President Trump's Chief of Staff, Reince Priebus, sent a memorandum to all heads of executive departments and agencies instructing a general regulatory freeze pending review, available here.

Is Delivery of ETNs to Settle Short Sales by Dealers within the Exemption from SEC Registration Provided by the Registered Hedging No-Action Letter?

The SEC Office of Capital Markets Trends has questioned whether short sales of exchange-traded notes ("ETNs") by broker-dealers and the closing out of short positions by borrowing ETNs from the issuer or its affiliates, as disclosed in the ETN prospectus, were registered under Section 5 of the Securities Act of 1933 (the "Securities Act"). This raises an interesting question as to whether the principles established in the registered hedging letter could be extended to cover short sales transaction in ETNs by dealers that are not affiliates of the ETN issuer. Issuers of ETNs should carefully review the plan of distribution sections of their ETN prospectuses to ensure that there is no inference that an affiliated broker-dealer is executing short sale transactions in the ETNs.

Read our article in *Futures and Derivatives Law Report*.

Upcoming Events

The New Benchmark for Financial Transactions
Tuesday, June 6, 2017
Morrison & Foerster Teleconference
Mark Schaedel and David Cook, IHS Markit & Peter Green and Jeremy Jennings-Mares, Morrison & Foerster LLP
12:00 p.m. – 1:00 p.m. EDT

The date for implementation of the new EU Regulation on indices used as benchmarks in financial instruments is January 1, 2018, which is rapidly approaching. The new Regulation will have a major impact on securities or other financial contracts in the EU that reference a financial benchmark (which is likely to include some customized proprietary indices).

Our speakers will be joined by representatives of IHS Markit, who will share their perspectives and address issues facing industry participants.

Topics will include: the principal features of the new Regulation and issues that need to be addressed by market participants; the effect on benchmarks administered outside the EU; and the relevant provisions of the Regulation and its practical implications for benchmark administrators, users, and contributors.

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

Keeping up with Regulatory Developments Affecting Social Media Use
Thursday, June 15, 2017
Morrison & Foerster Teleconference
12:00 p.m. – 1:00 p.m. EDT

This session will focus on the considerations for issuers, broker-dealers, registered investment advisers, and commodity pools in using social media, whether for corporate communications or in the context of securities offerings.

Topics will include: Reg FD and other liability concerns; FINRA guidance on communications and social media; social media for "business" versus "personal" use by employees of financial services firms; SEC guidance for investment advisers; general solicitation; and CFTC and NFA guidance for funds.

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

Join Our *Structured Thoughts* LinkedIn Group

Morrison & Foerster has created a LinkedIn group, *StructuredThoughts.* The group serves as a central resource for all things *Structured Thoughts*. We have posted back issues of the newsletter and, from time to time, will disseminate news updates through the group.

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

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Fortunately for us, we don't.

For the third year in a row, *GlobalCapital* has named us the Americas Law Firm of the Year at their 2017 Americas Derivatives Awards. We were also named 2016 Global Law Firm of the Year by *GlobalCapital* for its Global Derivatives Awards.

Our gratitude to *GlobalCapital* magazine for this recognition is exceeded only by our appreciation for our clients, whose imagination, energy and efficacy inspires us to do our most innovative work.

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

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.