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# Structured Thoughts

News for the financial services community.

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## What to Expect in 2015?

Here are our thoughts on what to expect in the structured products area in 2015.

**Dodd-Frank-Related Developments**

*The Volcker Rule*: Last year at about this time in December, we were still working our way through the final Volcker Rule. A year has passed and we are still attempting to understand the exceptions that may be available in connection with hedging of exposures arising in connection with the issuance of structured products. We anticipate that there will be additional regulatory guidance on the Volcker Rule. In fact, in their public statements, Federal Reserve representatives have alluded to possible changes relating to the metrics and compliance policy requirements. We anticipate that market participants will continue to work diligently to formulate compliance policies and procedures designed to address the hedging activities in relation to structured products, as well as their market making activities.

*Section 621 of the Dodd-Frank Act*: Since the SEC released a proposed rule in 2011 (Rule 127B of the Securities Act) to implement this Dodd-Frank provision, there has been no further activity. The rule would generally prohibit certain persons involved in the structuring, creation and distribution of an asset-backed security from engaging in transactions within one year after the date of the first closing of the sale of such ABS that would involve or result in a material conflict of interest with respect to any investor in such ABS. As we noted in our last year's recap, depending on the ultimate definition of "asset-backed security" for these purposes, certain structured products may be covered by the rule's prohibition on conflicts.



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*Title VII*: At this stage, market participants already have adopted approaches to address their hedging activities related to structured products, to the extent that in hedging, "swaps" are used. We still await final SEC rules relating to security-based swaps.

*CPOs*: During 2014, the Staff of the CFTC has provided additional relief to various types of vehicles that, in the absence of such guidance, may have been viewed as commodity pools. However, the CFTC exemptive relief does not address trusts used to issue credit-linked or insurance-linked notes, so these transactions merit special attention.

*Volcker Covered Funds:* Similarly, any trust or similar passive vehicle used to "repackage" bonds should be closely examined as it may be a "covered fund" for purposes of the Volcker Rule.

*Removing References to Ratings*: As we noted in last year's round-up, one of the objectives of the Dodd-Frank Act was to ensure that regulations did not incorporate references to credit ratings as that might cause undue reliance by investors and others on ratings. The SEC has not finalized amendments to Regulation M to eliminate ratings. Depending on the reformulation, this may have an effect on structured products offerings, such as variable price re-offer deals.

*Fiduciary Duty:* Recent statements made by representatives of the SEC suggest that the imposition of a fiduciary duty is still being considered closely, although the timing is uncertain.

*Bank Capital and Related Rules:* The principal elements of the Basel III framework were implemented in the United States in July 2013. In 2014, the banking agencies implemented a final liquidity coverage ratio and a final supplemental leverage ratio for the largest banks. In addition, the banking agencies have proposed a capital surcharge for the largest banks. In the meantime, the BCBS has completed its work on the net stable funding ratio framework and the Financial Stability Board has outlined a proposal relating to TLAC, or total loss absorbing capacity. Given that financial institutions are the principal US issuers of structured products, it can be expected that as banks begin to address the cumulative effect of these capital and liquidity measures, their perspective on the types of financial instruments they issue may change. Also, rating agencies likely will continue to refine their ratings assessment of financial institutions based on regulatory changes, and this may affect pricing.

**FINRA Developments**

It has been a relatively quiet year in the sense that FINRA has not issued any investor alerts or regulatory notices related principally to structured products. This should not be viewed as any indication that FINRA has lost its interest in, or focus on, structured products. As representatives of FINRA have made clear in their public remarks, FINRA continues to watch this segment of the market closely. We anticipate that FINRA will continue to monitor how member firms approach:

*Complex Products*: FINRA representatives have noted that they are particularly interested in the policies and procedures that firms have implemented relating to vetting new products that may be deemed complex products, as well as conducting post-sale reviews of such products.

*KYD*: FINRA representatives have addressed the types of diligence inquiries that "manufacturers" of structured products should undertake in connection with distributors of these products.

*Conflicts of Interest Policies and Disclosures*: FINRA remains focused on the policies and procedures that member firms implement in order to address conflicts of interest. In the structured products area, FINRA has focused on: conflicts that may arise as a result of the various roles that legal entities within a financial institution may play in the context of a structured product issuance (e.g., issuer, affiliated broker-dealer as underwriter, related party as calculation agent, etc.), conflicts that may arise where brokers are compensated differently in relation to sales of structured products, actual or potential conflicts arising in connection with any proprietary index used as a reference asset, etc.

*Reverse Inquiry*: Offerings that begin their lives as reverse inquiry transactions and then are more broadly offered and sold seem to be an area that is under scrutiny.

*Performance Data or "Hypothetical Backtested Data"*: FINRA continues to raise concerns that retail investors place undue reliance on hypothetical backtested data used in marketing materials. Of course, this type of information can be

used in issuer-prepared materials filed with the SEC. We anticipate that the discussion on backtested data will continue given that many European regulators expressly require such data to be produced and shared with investors.

**Other Developments**

*Benchmark Indices:* European regulators and IOSCO remain focused on the potential issues relating to "benchmark indices." Although European legislation regulating benchmark indices has not been adopted yet, both ESMA/EBA and IOSCO have released their principles and global institutions should review their indices in light of these best practices.

*Disclosure Reform:* the SEC Staff has been undertaking a review of current disclosure requirements. We are hopeful that, as a result of this process and dialogue relating to streamlining disclosure to make it more investor-friendly and accessible, we will have an opportunity in the future to revisit many of the lengthy disclosures that have become a fixture in the structured products market.

# EU Regulatory Agenda: Into 2015

2014 was an active year for financial regulation in the EU with a push to finalize much of the outstanding primary legislation on the regulatory reform agenda in advance of the European Parliamentary elections in May 2014. This resulted in the adoption of many EU Regulations and Directives in the first half of the year. There is still, however, some outstanding legislation still going through the EU legislative process, and much of the legislation that has been adopted envisages further legislation and regulation in the form of delegated regulations to be adopted by the EU Commission comprising technical standards to be drafted by the European Supervisory Authorities (the "ESAs")[1]. We have set out below the likely key areas of activity during 2015.

*Derivatives Reporting.* The European Market Infrastructure Regulation ("EMIR"), providing for the regulation of derivatives in the EU, has been in force since 2012 but many of the key provisions are only now beginning to come into effect. Rules requiring reporting of derivative transactions to trade repositories started to be phased in from February 2014 and are now largely implemented. There were, however, some difficulties in implementation of the rules which represented a logistical and administrative challenge for many market participants. Many of these issues have now been resolved, but in November 2014 ESMA proposed various changes to the relevant technical standards to seek to resolve certain issues. It is therefore likely that there will be some technical amendments to the derivatives reporting regime in early 2015.

*Derivatives Clearing.* Provisions in EMIR requiring the central clearing of many OTC derivatives are not yet in operation, but the implementation process is well underway. In 2014 ESMA published a number of draft technical standards setting out the initial classes of derivatives it proposes be subject to the clearing obligation, including many vanilla interest rate derivatives, credit derivatives referencing certain untranched credit indices and some non-deliverable fx forwards. ESMA proposes a phase-in for the clearing obligation based on four categorizations of counterparties with the largest and most active market participants being required to clear first. Category 1 entities will be required to clear transactions six months after the date the applicable technical standards come into force, which means such entities are likely to be subject to the clearing obligation for relevant derivatives from around August 2015.

*Derivatives – Collateralization of Uncleared Transactions.* In April 2014, the ESAs published technical standards on risk mitigation techniques for the collateralization of uncleared derivatives transactions. The proposals included the collection of both variation margin during the life of the transaction and initial margin upon inception of the trade. Assets provided as collateral are subject to eligibility criteria. Once received, margin must be segregated from proprietary assets of the relevant custodian, and initial margin cannot be rehypothecated. The collateralization of uncleared trades will be phased in from December 1, 2015, although only the largest market participants (those trading non-centrally cleared derivatives in excess of €3 trillion in monthly aggregate notional amount) will initially be subject to the rules. All counterparties trading such derivatives in excess of €8 billion will be subject to the requirements by December 2019.

[1] The ESAs comprise the European Securities and Markets Authority ("ESMA"), the European Banking Authority (the "EBA") and the European Insurance and Occupational Pension Authority ("EIOPA").

*MiFID II*. MiFID II is the overhaul of the Markets in Financial Instruments Directive and comprises a Regulation ("MiFIR") and recast Directive. It came into force in August 2014 but does not become effective until January 2017. ESMA is due to publish many draft technical standards during 2015, including in relation to provisions relating to investor protection, market infrastructure, exchange trading of derivatives and pre and post-trade transparency requirements for bonds, structured finance instruments and derivatives traded on a trading venue. ESMA published a Consultation Paper and a Discussion Paper in July 2014 outlining its initial views, and a second consultation paper is expected in December 2014.

*PRIIPs.* The Regulation on key information documents ("KIDs") for packaged retail and insurance-based investment products ("PRIIPs") comes into force on December 29, 2014, although it does not become effective until December 2016. When a person is advising on or selling a PRIIP to retail investors, a pre-contract KID must be provided to the investor. The Regulation contains detailed requirements as to the form and content of the KID. In November 2014, the ESAs released a joint discussion paper setting out their thoughts as to the presentation and content of each element of the KID content and other matters including the methodology underpinning the presentation of risk and reward. The ESAs are expected to publish a consultation on draft technical standards and a further technical discussion paper during 2015.

*Benchmark Regulation*. The use of benchmarks in financial transactions has been in focus in recent years following alleged misconduct in relation to the setting of LIBOR and other financial benchmarks. In July 2013, the International Organization of Securities Commissions ("IOSCO") published principles for financial benchmarks, and in September 2013 the EU Commission published a draft regulation in relation to indices used as benchmarks in financial instruments and contracts, which seeks to impose various obligations on benchmark administrators, contributors and users. Administrators located in the EU will be subject to authorization and supervision by their competent authorities and be subject to detailed governance and reporting requirements. The legislative process will continue into 2015, and there are likely to be considerable efforts to finalize the Regulation during the year.

*BRRD / Bail-in.* Under the Bank Recovery and Resolution Directive (the "BRRD"), unsecured structured notes and other structured products issued by a bank will be liable to be written off or converted into equity instruments by a national resolution authority if the bank enters into resolution. Such authority will also be able to terminate and close out derivatives contracts of an EU bank as part of the resolution process and bail-in the resulting net liability. These concepts are consistent with the "Key Attributes of Effective Resolution Regimes for Financial Institutions" updated by the Financial Stability Board ("FSB") in October 2014. Surprisingly, the FSB has proposed that structured notes will not be counted towards the required minimum levels of bail-inable liabilities that it recommends a global systemically important bank must maintain. There is likely to be further discussion on this issue into 2015.

*Structural Banking Reform.* Based on the current proposed form of the EU Bank Structural Reform Regulation, the structured products and related activities of in-scope entities should not constitute prohibited proprietary trading, due to their connection to actual or anticipated client activity. However, in-scope entities that accept insured deposits will remain subject to the possibility of being forced to separate off structured products or other activities, if their national competent authority decides that the activities pose a threat to the financial stability of the institution or the EU financial system as a whole. The draft Regulation is still in the early stages of the EU legislative process and is subject to further debate and negotiation during 2015.

*Banking Reform Act in the UK*. In the UK, it looks likely that a ring-fenced bank (broadly, a bank engaging in significant non-institutional deposit-taking) will not be permitted to sell structured products or derivatives unless they fall within a specified range of hedging transactions for customers. In addition, it seems that neither their subsidiaries, nor their parent companies will be able to engage in such activities, and banking groups that contain a ring-fenced bank will need to engage in these activities through "sibling" entities. These proposals are controversial and likely to be subject to further debate into 2015. The ring-fence will not come into force until 2019, but banks are already planning the transition to the new regime.

*AIFMD.* The Alternative Investment Fund Managers Directive ("AIFMD") came into effect in July 2013 and governs the management and marketing of alternative investment funds ("AIFs") by Alternative Investment Fund Managers ("AIFMs") in the EU. Non-EU AIFMs marketing one or more AIFs to professional investors in an EU country are currently required to comply with that country's AIFMD implementing legislation irrespective of the domicile of such AIFs. However, such non-

EU AIFMs cannot benefit from the AIFMD marketing passport across the EU until the European Commission implements delegated legislation extending the passporting regime to non-EU AIFMs (following a positive opinion from ESMA). This is expected to be in place by the end of 2015 but until then non-EU AIFMs can only actively market AIFs to professional investors in the EU in accordance with the relevant national private placement regime.

*Financial Transactions Tax*. Despite lack of support for an EU-wide financial transactions tax ("FTT"), 11 Member States[2] are proceeding with proposals to harmonize legislation on the indirect taxation of financial transactions with a tax of 0.1% on all transactions relating to financial instruments other than derivatives which will attract a tax rate of 0.01% on the notional amount of the transaction. The UK challenged the proposals based upon, among other things, their potential extraterritorial effect but this was rejected by the European Court of Justice, at least for the time being. The legislative process somewhat stalled during 2014 but the EU Council indicated in November 2014 that work will be intensified amongst the relevant member states during 2015. Further legislative proposals are likely sometime in the New Year.

*UCITS V*. The UCITS V Directive came into force in September 2014, and EU member states have until 18 March 2016 to transpose it into their national laws. It makes various changes to the existing UCITS Directive, principally seeking to make provisions relating to depositaries and remuneration rules for management companies more consistent with those applicable to AIFs under the AIFMD. A number of delegated acts and technical standards must be adopted by the EU Commission, and ESMA has published technical advice, including in relation to insolvency protection of the assets of a UCITS when the depositary has delegated safekeeping duties to a third party and the requirements on the management company and depositary to act independently. The EU Commission is likely to finalize the delegated acts during 2015.

## FINRA Issues Report Relating to its Communication Rules

FINRA's communications rules affect the content, required approvals and potential filings of broker-dealer communications relating to structured products.[3] FINRA's 2013 amendments to the communications rules had specific applications to this market, resulting in a variety of changes to the offering process for many structured notes.

In April 2014, FINRA launched a review of its communications rules, as part of an ongoing initiative "to periodically look back at significant groups of rules to ensure they remain relevant and appropriately designed to achieve their objectives, particularly in light of industry and market changes." The review involved discussions with, and written comment submissions by, a wide variety of market participants.[4] In December 2014, FINRA issued its report regarding its review.[5] The report describes the responses of market participants and the potential nature of FINRA's planned rulemaking process. This process may result in changes to the communications rules that would affect the structured products industry.

**FINRA Filing Requirement**

The 2013 amendments to the communications rules required the filing with FINRA of certain types of materials used in connection with registered public offerings of structured notes. According to the report, many respondents believe that the filing requirements are overbroad in some respects relative to the investor protection they provide. They stated that the filing requirements impose significant direct and indirect costs on firms, and potentially divert FINRA resources from higher-risk matters. Some firms also indicated that the high volume of materials filed with FINRA has resulted in a backlog of filings to be reviewed; stakeholders also expressed some frustration with the turnaround times for review of communications, and encouraged FINRA to explore ways to make more efficient use of its review resources.[6] Many

[2] Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia
[3] The communications rules consist of FINRA Rule 2210 (which is generally most relevant to structured products) and Rules 2212-2216.
[4] FINRA invited public comment in its Regulatory Notice 14-14:
https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p479810.pdf .
[5] The report may be found at the following link: http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p602011.pdf .
[6] If you have tried recently (for example) to have a financial institution's proposed structured products website reviewed by FINRA, it is possible that you share that view.

broker-dealers suggested that a risk-based approach to filing would be a better use of both broker-dealer and FINRA resources.

**Contents and Length of Disclosures**

Rule 2210(d) requires disclosures in retail communications to be "fair and balanced," and not misleading. But of course, in connection with most marketing materials, there are judgments to be made as to what that standard means, and how it should be applied. In connection with its comment process, the FINRA Advertising Department has often requested that broker-dealers expand the content of these documents, particularly with respect to risk factors.

As a result, FINRA indicated in the report that market participants asserted that the amount of required disclosure has become disproportionate to the substance of marketing materials, reducing the value of these materials to investors and potentially giving the impression that the risks of an investment outweigh its benefits. Some also asserted that the FINRA staff expects almost as much risk disclosure in sales material as is contained in the statutory prospectus for the relevant offerings. They further stated that FINRA's staff interpretations of the content standards do not allow for layered disclosure (such as hyperlinks or references to other sources of information or offering documents), which would be more efficient and effective. They also asserted that these disclosure requirements discourage materials that would educate investors about strategies (e.g., diversification), products, services, fees and expenses.

To date, FINRA has also restricted the use of some types of information, particularly back-tested performance information as to proprietary indices and strategies, in materials intended for retail investors. Accordingly, many respondents favored more permissive use of this type of information.

**Clarity and Transparency of FINRA Reviews**

According to the report, market participants asserted that the principles-based content standards of the communications rules lead to a variety of challenges. Some asserted that the key content standards—e.g., "principles of fair dealing," "fair and balanced," "exaggerated" and "unwarranted"—are too subjective. While they indicated that FINRA's guidance to date has been helpful, they generally suggested that this type of guidance needs to be more frequent, and needs to capture the Advertising Department's comments in a consolidated way. For example, unlike in most SEC comment letters to issuers, there is no public source of information for FINRA's comments, or for the guidance contained in those comments.

Similarly, each broker-dealer has its own assigned reviewer, and it is possible that different reviewers have different opinions and judgments as to these disclosures. Accordingly, some commenters expressed the view that analyst reviews could be performed in a more consistent manner.

**Expense of Reviews**

Commenters asserted that the direct costs of filing and re-filing, including expedited filing fees when a broker ceases to use materials quickly, can be significant. Many firms also indicated that the indirect costs associated with filing and re-filing exceed those direct costs-- most significantly, the personnel and technology resources needed for the compliance functions required by the rules. One person asserted that the rules are anticompetitive, because they make FINRA a "marketing partner for firms" that file materials and pay a fee to have their communications reviewed.

**Conclusion**

FINRA believes that its review demonstrates widespread agreement among affected parties that its communications rules "have been largely effective in meeting their intended investor protection objectives. However, the rules and FINRA's administration of them may benefit from some updating and recalibration to better align the investor protection benefits and the economic impacts."

With particular relevance to structured products, according to the report, FINRA's staff recommends the initial consideration of:

- aligning FINRA's filing requirements and review process with the relative risk of the communications;

- facilitating simplified and more effective risk disclosure; and
- providing more guidance regarding application the of FINRA's content standards, including exploring the adoption of comprehensive performance standards.

Over the next several months, FINRA expects to explore a combination of guidance, proposed rule modifications and administrative measures to enhance the effectiveness and efficiency of the rules. In the upcoming action phase, FINRA will engage in its typical rulemaking process to propose any amendments to the rules based on the assessments.

## Structured Product Offerings and RIAs

**Introduction**

Registered investment advisors (RIAs) have emerged as a significant sales channel for many distributors of structured products. RIAs advise investors with a variety of investment needs, and often help generate some of the most interesting ideas for new structured products. This article discusses RIAs, some aspects of the regulatory regime that applies to them, and the documentation used in connection with sales through this channel.

**What Are RIAs?**

A RIA is a professional advisory firm that provides financial advice to clients. The advice is typically intended to be personalized for a particular investor's needs. An investment adviser that meets certain criteria is required to register under the Investment Advisers Act of 1940 (the "Advisers Act"),[7] hence the term, "registered" investment adviser. In many cases, the accounts advised by RIAs represent affluent investors, or significant investment funds. After a RIA learns about a new type of product, and concludes that it is appropriate for one of its accounts, it will often consider additional accounts for which that product or similar products may be worthwhile. Accordingly, RIAs have emerged as an important distribution channel for many broker-dealers that offer structured products.

Unlike broker-dealers, which are required to undertake a suitability determination before recommending a security to an investor, investment advisors are subject to fiduciary duties in making a recommendation. Of course, this distinction between broker-dealers and investment advisers is subject to new rulemaking as a result of the Dodd-Frank Act, and may change in the not-so-distant future.

**How Sales Are Made Through RIAs**

RIAs may be authorized by contract to make investment decisions on behalf of investors (a "discretionary account"). Alternatively, an RIA may simply provide investment advice, and in connection with any particular sale, the investor advised by the RIA may make the actual investment decision. In either case, the broker-dealer's communications are typically conducted with the RIA, and the offering documents are provided by the broker-dealer through the RIA.

In connection with structured product sales, products offered on a weekly or monthly calendar basis may be offered to RIAs. In addition, many RIAs are involved in "reverse inquiry" transactions, in which an RIA approaches a broker-dealer with a request for a particular structure, or approaches multiple broker-dealers with a request for "competitive bids."

**RIAs and FINRA's Suitability Rules**

Accounts advised by RIAs are deemed to be "institutional accounts" under the FINRA rules.[8] Because of these relationships, the broker-dealer that offers the product is subject to a more limited set of suitability requirements under FINRA Rule 2111 when selling to accounts that are advised by RIAs. A broker-dealer fulfills the customer-specific suitability obligation for an institutional account if:

[7] See Section 203 of the Advisers Act.
[8] See NASD Rule 4512(c).

- the broker has a reasonable basis on which to believe that the institutional customer is capable of evaluating investment risks independently; and

- the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations.

Rule 2111 does not require a broker-dealer to have a hard-copy agreement on file showing that an institutional customer intends to exercise independent judgment; a firm can take a risk-based approach to documenting it.[9]

We note that this reduced suitability requirement relates to customer-specific suitability. The broker-dealer remains subject to FINRA's reasonable basis suitability requirements with respect to the development and offering of the product itself.[10]

**RIAs and FINRA's Communications Rules**

Communications from broker-dealers to RIAs are also subject to a somewhat easier compliance burden under FINRA's communications rules. Communications designed exclusively for RIAs, as opposed to those for a typical individual investor, are deemed to be "institutional communications" under Rule 2210(a)(3) as opposed to "retail communications."

**RIAs and FWPs (A Little Alphabet Soup)**

As discussed above, many RIAs have the ability to make investment decisions on behalf of the investors that they represent. Accordingly, in many cases, preliminary term sheets and other offering documents provided to RIAs will be "free writing prospectuses" for purposes of the Securities Act. However, these documents will not be subject to any filing requirement with the SEC:

- many of these documents will be "preliminary term sheets" that are not subject to filing under Rule 433(d)(5)(i); and

- many of these documents will be "underwriter free writing prospectuses" that are not subject to filing under Rule 433(d)(1)(i).

**Agreements Between Brokers and RIAs**

In light of the regulations outlined in this article, a variety of common provisions can be identified in the agreements that are often executed between broker-dealers and RIAs relating to the sales of structured products and other instruments.

First, we note that RIAs are often thought of as the "customers" of the broker-dealers who are selling to them. Accordingly, broker-dealers are sensitive to the possibility of rendering themselves unattractive to RIAs by offering up an over-detailed and lengthy agreement, particularly when an RIA does not have an in-house legal department that can review and negotiate these documents efficiently. Similarly, RIAs are not broker-dealers and are not acting like broker-dealers; accordingly, the typical "master selected dealer" or similar agreement will typically not be appropriate for a relationship with an RIA.

*Representations*. In addition to the possibility of customary housekeeping representations, the RIA will represent as to its registered status under, and compliance with, the Advisers Act.

*Authority to Make Investment Decisions*. A broker-dealer will typically communicate with the RIA, as opposed to with the accounts that the RIA represents. Accordingly, the RIA will often represent that it possesses the authority to make investment decisions on behalf of its customers.

*Investment Judgment*. In selling through the RIA network, RIAs would prefer to be subject to the reduced suitability standard that FINRA applies to institutional accounts. As a result, a typical agreement with an RIA will have the RIA

[9] See discussion below relating to the agreements that may be entered into between broker-dealers and RIAs.
[10] See FINRA Notice to Members 12-03.

confirm that it is exercising independent judgment in making an investment decision with respect to the relevant instrument.

*Offering Materials*. An RIA will agree to provide on a timely basis to the relevant accounts any offering materials and securities confirmations provided by the broker-dealer. In order to help ensure that any materials prepared for institutional accounts only do not inadvertently become subject to FINRA's retail communications rules, the RIA will typically also agree not to provide any materials to investors that the broker-dealer or issuer have not authorized for that purpose.

Any such agreement will be typically designed to refer over time to multiple offerings, and to be reaffirmed at the time that each sale is made.

**RIA Compensation and Structured Notes**

RIAs are often compensated by investors based upon their assets under management. Typically, they will not receive a brokerage or similar fee at the time of a pricing or settlement, as broker-dealers do. Accordingly, sales through this channel can often be made at a lower purchase price, or with slightly improved offering terms, as compared to sales in which brokerage fees need to be factored into the economics.

In the case of registered structured notes, these arrangements will often result in securities that have an estimated initial value that is closer to par than that of some other types of offerings. In addition, where securities are sold at par through brokerage accounts, and simultaneously at a discounted price to advisory accounts, the cover page of the offering documents will disclose this differential in order to comply with FINRA's fixed price rules.

## The SEC, Investment Funds and Derivatives

In a December 2014 speech in New York, SEC Chair Mary Jo White discussed a variety of issues relating to registered investment funds. A number of her statements relate to potential rule-making activity involving investment funds and their use of derivatives.

The full text of her speech may be found at the following link:
http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VJCd7010wy4

Our more detailed discussion of her remarks may be found at the following link:
http://www.bdiaregulator.com/2014/12/sec-to-require-living-wills-and-stress-testing-for-investment-advisers/

A few relevant excerpts from that discussion are set forth below:

The SEC is considering new rules that would require standardized reporting for derivatives used by funds and securities lending. The data-collection efforts may extend to private funds.

- Our take: We can expect the SEC to require registered funds and private funds to report specific data concerning derivatives holdings and securities lending activities more regularly. This data might be used for the SEC's surveillance and enforcement efforts, in a manner similar to how the SEC plans to use data derived from public company financial reporting and audit trail information.

Controls on risks related to portfolio composition: White identified liquidity risks and the use of derivatives as key staff priorities. Registered funds must establish controls that identify and manage those risks.

Consistent with the January 2014 guidance published by the Division of Investment Management, White said that the staff is concerned that mutual funds may have difficulty meeting redemptions if portfolios come under stress and are forced to sell securities at fire-sale prices, which, inturn, could drive down asset prices for other funds and other investors. The staff also is concerned that funds' use of derivatives frequently results in "leveraged investment exposures and potential future obligations that can create risks."


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White called for a "comprehensive approach" to address risks related to liquidity and derivatives. While White was short on specifics, she said that the SEC's staff is reviewing options such as updated liquidity standards, disclosures of liquidity risks, or limits on leverage created by use of derivatives.

- Our take: It is not clear what the actual rule proposals would look like. An educated guess is that the SEC will refine the definition of "liquidity" — that is, when a fund should consider an investment to be illiquid. The current definition is buried in instructions to Form N-1A and, most recently, the 2014 amendments to the money market fund rules. A new definition may be more market-oriented, taking into account the perceived tightening of the fixed income market and shrinking bond inventories. The SEC may also attempt to pull in the reigns on leverage, or tighten asset segregation requirements. In any event, these proposals are likely to generate substantial controversy and public comment.

## SEC Extends Temporary Rule for Adviser Principal Trades

The SEC has extended by two years its temporary rule that provides an alternative means for registered investment advisers that are also registered as broker-dealers to meet the requirements of Section 206(3) of the Investment Advisers Act of 1940 (the "Advisers Act"). This provision, Rule 206(3)-3T, applies when investment advisers act in a principal capacity in transactions with certain of their advisory clients. Absent SEC action, the rule would have sunset on December 31, 2014. As a result of the SEC's action, the Rule's new sunset date is December 31, 2016.

Section 206(3) of the Advisers Act prohibits registered investment advisers from engaging in principal transactions with their clients unless they obtain written consents for each individual principal transaction. Without an alternative means of complying with this restriction, many advisers refrained from engaging in principal trades with their clients, including those in fee-based advisory accounts, due to the impracticality of promptly obtaining written consents for each transaction.

Rule 206(3)-3T provides an alternative means for investment advisers to comply with the limitations of Section 206(3). Among other things, the adviser must make certain disclosures to clients about conflicts of interest. The adviser must obtain written, revocable consents that prospectively authorize principal transactions. Under these circumstances, the Rule then permits the investment adviser to obtain either written or oral consent from the client with respect to each individual principal transaction. The availability of oral consent facilitates prompt decisions before there are changes in the market price of the security.

In adopting the extension, the SEC indicated that it continues to believe that the issues raised by principal trading, including the restrictions in Section 206(3) of the Advisers Act and its experiences with, and observations regarding, the operation of Rule 206(3)-3T, should be considered as part of its broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers in connection with the Dodd-Frank Act.

## FINRA Proposes New Rules on Debt and Equity Research Reports

On November 14, 2014, FINRA published two proposed rule changes, covering debt and equity research reports and research analysts. FINRA proposed to adopt current NASD Rule 2711 (Research Analysts and Research Reports) as FINRA Rule 2241, with several modifications. FINRA also proposed adopting new Rule 2242 (Debt Research Analysts and Debt Research Reports), which is designed to address conflicts of interest relating to the publication and distribution of debt research reports.

The current rules covering equity research, NASD Rule 2711 and Incorporated NYSE Rule 472, set forth requirements to foster objectivity and transparency in equity research, and provide investors with more reliable and useful information to make investment decisions. The proposed rule change would retain the core provisions of the current rules and, among other objectives, broaden members' obligations to identify and manage research-related conflicts of interest. Rule 2242

would provide retail debt research recipients with extensive protections similar to those provided to recipients of equity research, but modified to reflect differences in the trading of debt securities.

The text of the proposed equity research rule changes can be found at:
http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p601676.pdf

The text of the proposed debt research rule can be found at:
http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p601678.pdf

Communications that include analyses of proprietary indices and baskets of equity securities are within the definition of "research report" in Rule 2241, as they are in the current equity research rules. A communication including an analysis of a broad-based index, such as the S&P 500, is not within the definition of "research report." Any communication including an analysis of a debt security, such as a structured note, would be a "research report" under proposed Rule 2242. Like Rule 2241, Rule 2242 provides that a communication including an analysis of a broad-based index is not a "research report," provided that the communication does not include an analysis of, or recommend or rate, individual debt securities or issuers. In each case, in order to constitute a research report, the communication must also provide information reasonably sufficient upon which to base an investment decision.

**Rule 2241 – Key Changes From the Current Rules**

**Identifying and Managing Conflicts of Interest**

The rule requires FINRA member firms to establish, maintain and enforce written policies and procedures reasonably designed to:

- Identify and effectively manage conflicts of interest related to the preparation, content and distribution of research reports, public appearances by research analysts and the interaction between research analysts and those outside of the research department, including investment banking personnel and sales and trading personnel; and
- Promote objective and reliable research and prevent the use of research reports or research analysts to manipulate or condition the market by, for example, prohibiting prepublication review, clearance or approval of debt research reports by persons engaged in investment banking services activities, and other individuals aside from legal and compliance personnel, or by a subject company, other than for verification of facts.

These provisions would, among other things, help insulate research analysts from structured products personnel seeking to influence the content of a research report relating to a proprietary index or a basket of equity securities, or a debt security linked to either type of underlying asset.

These policies and procedures must also, at a minimum, include the following:

- Establish information barriers or other institutional safeguards to ensure that research analysts are insulated from the review, pressure or oversight by persons engaged in investment banking services activities or other persons, including sales and trading department personnel, who might be biased in their judgment or supervision;
- Restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity, such as participation in pitches, road shows and other marketing on behalf of issuers;
- Limit the determination of a firm's research department budget to senior management, excluding senior management engaged in investment banking services activities, and without regard to specific revenues or results derived from investment banking;
- Prohibit compensation based upon specific investment banking services transactions or contributions to a member's investment banking services activities;

- Require that the compensation of a research analyst who is primarily responsible for preparation of the substance of a research report be reviewed at least annually by a committee that reports to a member's board of directors or, if the member has no board of directors, a senior executive officer of the member;
- Prohibit investment banking personnel from directing research analysts to engage in sales or marketing efforts related to an investment banking services transaction or any communication with a current or prospective customer about an investment banking services transaction;
- Restrict or limit trading by a research analyst account in securities, derivatives and funds whose performance is materially dependent upon the performance of securities covered by the research analyst:
  - For example, a research analyst would be prohibited from trading in a structured note that is linked to a single stock, proprietary index or equity basket that, in each case, is covered by that research analyst;
- Prohibit direct or indirect retaliation or threat of retaliation against any research analyst by any employee of the member or its affiliates as the result of an adverse, negative or otherwise unfavorable research report or public appearance written or made by the research analyst that may adversely affect the member's present or prospective business interests;
- Prohibit joint due diligence activities — i.e., due diligence by the research analyst in the presence of investment banking personnel — prior to the selection of underwriters for the investment banking services transaction;
- Prohibit explicit or implicit promises of favorable research, a particular research rating, or recommendation or specific research content, as inducement for the receipt of business or compensation; and
- Define "quiet periods" of a minimum of 10 days after an initial public offering, and a minimum of three days after a secondary offering, during which a member must not publish or otherwise distribute research reports, and research analysts must not make public appearances, relating to the issuer if the member has participated as an underwriter or dealer in the initial public offering, or, with respect to secondary offerings, as a member or co-manager of that offering.[11]

**Content and Disclosure in Research Reports**

The rule covers the content of research reports, particularly with respect to the use of ratings.

FINRA members must establish, maintain and enforce written policies reasonably designed to ensure that purported facts in its research reports are based on reliable information, and that any recommendation or rating has a reasonable basis and is accompanied by a clear explanation of any valuation method used and a fair presentation of the risks that may impede achievement of the recommendation, rating or price target. If a rating system is employed, the member must define in each research report the meaning of each rating in the system, including the time horizon and any benchmarks on which a rating is based.

Potential conflicts of interest relating to a research report must be disclosed, including:

- If the research analyst or a member of his or her household has a financial interest in the debt or equity securities of the subject company, and the nature of such interest;
- Any compensation received by the research analyst based upon the FINRA member's investment banking, sales and trading or principal trading revenues;
- If the member or any of its affiliates managed or co-managed a public offering of securities for the subject company in the past year, or received compensation for investment banking services from the subject company in the past year;

[11] The conflicts of interest provisions of Rule 2242 are substantially similar to those of Rule 2241, except that the provisions relating to "quiet periods" are unique to Rule 2241.

- If the member or its affiliates maintain a significant financial interest in the debt or equity securities of the subject company, including, at a minimum, if the member or any of its affiliates beneficially owns 1% or more of any class of common equity securities of the subject company;
- If the member was making a market in the securities of the subject company at the time of publication or distribution of the research report; or
- Any other material conflict of interest of the research analyst or member that the research analyst or an associated person of the member with the ability to influence the content of the research report knows of or has reason to know of at the time of the publication or distribution of the research report.

Similar disclosures must be made in a public appearance by a research analyst.[12]

**Timing of Research Reports**

Members must establish, maintain and enforce written policies and procedures reasonably designed to ensure that a research report is not distributed selectively to trading personnel or a particular customer or class of customers in advance of other customers that the member has previously determined are entitled to receive the research report.

**Unique Features of Rule 2242**

Rule 2242 (debt research) differs from the current equity research rules in three respects:

- The rule delineates the prohibited and permissible communications between debt research analysts and principal trading and sales and trading personnel;
- The rule adopts a tiered approach by exempting debt research provided solely to institutional investors from many of the structural protections and prescriptive disclosure requirements that apply to research reports distributed to retail investors; and
- The rule has exemptions from certain of its provisions for members that engage in limited principal trading activity.[13]

**Exemption for Debt Research Reports Provided to Institutional Investors**

Debt research distributed solely to eligible institutional investors is exempted from most of the provisions regarding supervision, coverage determinations, budget and compensation determinations and all of the disclosure requirements applicable to debt research reports distributed to retail investors. A “retail investor” means any person other than an institutional investor.

The rule allows firms to distribute institutional debt research by negative consent to a person who meets the definition of a “qualified institutional buyer” (QIB) as defined in Rule 144A under the Securities Act of 1933 and where, under FINRA Rule 2111(b) (Suitability):

- The member or associated person has a reasonable basis to believe that the QIB is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a debt security or debt securities; and
- The QIB has affirmatively indicated that it is exercising independent judgment in evaluating the member’s recommendations under Rule 2111 and the affirmation is broad enough to encompass transactions in debt securities.

[12] The content and disclosure provisions of Rule 2242 are substantially similar to those of Rule 2241, except that Rule 2242 requires disclosure of whether the member may trade as a principal in the debt securities (or related derivatives) that are the subject of the debt research report. Rule 2242 does not include the fourth or fifth bullet points in this list.

[13] Both rules have exemptions from certain provisions for firms with limited investment banking activities.

The rule requires written disclosure to the QIB that the member may provide debt research reports that are intended for institutional investors and are not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors. If the QIB does not contact the member and request, to receive only retail debt research reports, the member may reasonably conclude that the QIB has consented to receiving institutional debt research reports. Institutional accounts that meet the definition of FINRA Rule 4512(c) but do not satisfy the higher requirements described above may still affirmatively elect in writing to receive institutional debt research.

## 12th Annual European Structured Products & Derivatives Conference 2015

Please Join Morrison & Foerster on February 5-6, 2015 at the Guoman Tower Hotel in London for the 12th Annual European Structured Products & Derivatives Conference. This two-day event will bring together senior representatives from retail banks, insurance companies, investment banks, fund managers as well as law firms, regulatory bodies and independent investment advisors to discuss the major challenges at this time.

Partner Jeremy Jennings-Mares will be giving the welcome address at the beginning of the second day, and Partner Peter Green will participate in the “Law Firm Roundtable.”

For more information, please visit:
http://www.mofo.com/resources/events/2015/02/150205annualeuropeanstructuredproducts12th

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Morrison & Foerster has been named Structured Products Firm of the Year, Americas, 2014 by *Structured Products* magazine for the sixth time in the last nine years. See the write-up at http://www.mofo.com/files/Uploads/Images/120530-Americas-Awards.pdf. Morrison & Foerster named Best Law Firm in the Americas, 2012, 2013, and 2014 by *Structured Retail Products.com*.

Morrison & Foerster named Legal Leader, 2013 by *mtn-i* at its Americas Awards. Several of our 2013 transactions were also granted awards of their own as a result of their innovation.

Morrison & Foerster named European Law Firm of the Year, 2013 by *Derivatives Week* at its Global Derivatives Awards.

## About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life sciences companies. We've been included on *The American Lawyer*'s A-List for 11 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com. © 2014 Morrison & Foerster LLP. All rights reserved.

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