

# Structured Thoughts

*News for the financial services community.*



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## **Suitability Update: Effective Date of New FINRA Rules**

In January 2011, FINRA announced that the SEC had approved FINRA's proposed updated rules relating to suitability and brokers' "know your customer" obligations. We previously described these provisions in Volume 1, Issue 13 of *Structured Thoughts*: <http://www.mofo.com/files/Uploads/Images/101004-Structured-Thoughts-Issue-13.pdf>.

Now that the SEC has approved them, these rules will become effective on October 7, 2011. FINRA's summary of the new rules, together with their provisions, may be found at: <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf>.

The final suitability rules, now set forth at Rule 2111, will implement a number of changes. Suitability determinations would apply to recommended investment strategies, and not only to recommendations relating to specific securities. There are three elements or components of suitability identified by the rule: reasonable basis suitability,<sup>1</sup> customer specific suitability<sup>2</sup> and quantitative suitability.<sup>3</sup>

<sup>1</sup> *i.e.*, the recommendation must be suitable for at least some investors.

<sup>2</sup> *i.e.*, the broker must have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile.

<sup>3</sup> *i.e.*, the broker must have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not unsuitable for the customer when taken together, in light of the investor's investment profile.

Each of these suitability tests is likely to be relevant to a particular offering of structured products. For example, in considering quantitative suitability, the broker-dealer should make a determination that a series of transactions, when viewed together, would be suitable for the client. Recommendations as to offerings of structured notes could violate the quantitative suitability test if, for example, they caused an investor's portfolio to be over-concentrated in a particular issuer's common stock, or over-concentrated in the credit of a particular structured note issuer.

The list of items included as part of a retail investor's profile would be expanded as part of new Rule 2111. These items will include age, other investments, financial situation and needs, tax status, investment objectives, investment experience and time horizon, liquidity needs and risk tolerance. The prior rule that Rule 2111 replaces listed a much smaller number of items.

The rule clarifies the means by which the customer suitability obligation may be discharged in respect of recommendations made to institutional accounts. This duty would be discharged if the broker-dealer has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently (both in general and with respect to particular transactions and investment strategies) and the customer affirmatively indicates that it is exercising independent judgment in evaluating the recommendation. An "institutional account" would include an institutional investor with \$50 million in assets under management.

We note that suitability and related concepts will be revisited following the completion of the SEC's study on standards of care, which was mandated by the Dodd-Frank Act.

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## Proprietary Indices

As the popularity of structured products linked to the performance of proprietary indices continues to grow, we receive more frequent questions regarding the legal and compliance issues arising in connection with these products. Below we summarize a number of the principal issues which arise under the securities laws and stock exchange rules, together with additional key considerations.

*Discretion:* consider whether the index is in any way discretionary. Are the index rules sufficiently detailed such that the index sponsor and the calculation agent can follow the rules without making judgments? If the index is discretionary, the elements of discretion may present compliance issues. For example, decisions made by the index sponsor or by the calculation agent that are deemed discretionary may be questioned in hindsight. There may be reason to consider whether, in making such decisions or determinations, the index sponsor or the calculation agent had conflicts of interest or was in possession of material non-public information. If an index is discretionary, it may present Investment Company Act issues, because the discretion may make the instrument seem like a "managed" investment or make the product seem like a "managed" fund (with the fund being the "pool" of referenced assets that comprise the index).

*Index rules:* the index rules will have to be set out in a detailed fashion, particularly in the context of a registered offering. This will be essential in order to be able to provide investors with complete disclosure regarding the index, including any risks that arise from these rules. The index sponsor itself also will want to have a detailed description of the index. If there is ever a need to transfer the index to another sponsor, this will become important. Similarly, if the structured product is listed on a securities exchange, a detailed description will be needed for the exchange, so that the exchange can review the eligibility of the structured product for listing.

*Information walls:* from a compliance perspective, the index provider, issuer and underwriter each should confirm for itself that the index is created by a separate group at the investment bank, separate from the product structurers and marketers. Indices are often created by special research teams. The product marketers should be walled off from those responsible for index creation, so that the marketers cannot influence the index features or its components.

*Window cleaning:* some proprietary indices with an equity component may from time to time represent a concentrated position in one or more equity securities. Where this occurs, it may be appropriate for the issuer and the underwriter to perform “window cleaning” procedures that are comparable to those that it uses when issuing a structured product linked to a small number of stocks, or when linking to a non-proprietary index that has a high concentration in a particular security.

*Leverage/roll features:* we are seeing more indices that incorporate leverage or “roll” features, as well as indices that incorporate algorithmic trading models or “black box” features. Particularly for indices that incorporate leverage features, it will be important to describe accurately the index, the leverage factor and the risks associated with a product linked to such an index. Commodity indices that incorporate roll features may exacerbate certain risks. Regulators have cautioned that investors should be forewarned of the risks associated with products incorporating leverage as well as the risks associated with commodity-linked products.

*Disclosure:* as with any structured product that is offered to investors, crafting complete, useful disclosure is essential. It may be more challenging to describe accurately and completely a structured product linked to an innovative proprietary index. Oftentimes, we see indices that incorporate financial modeling or complex equations, and it may be challenging to describe the index methodology in plain English or to do so effectively without sacrificing accuracy. For products that are intended to be marketed and sold to retail investors, the parties should consider whether it is preferable to include the plain English description or whether it is helpful to include the formulas or other tables in the offering document. Particular care should be given in preparing the “historical” index levels to make clear that historical results are not actual, and if necessary, the nature of any assumptions used to create the historical information.

*New product review:* linking to a proprietary index may constitute a “new product.” In such case, broker-dealers will need to adhere to relevant regulatory guidance, such as NASD Notice 05-26 (April 2005) relating to reviewing new products.

*Suitability:* as in the case of any new financial product, the relevant underwriters will have to verify the suitability of the proposed product. In addition to ensuring that the product is suitable to a particular investor before making an investment recommendation as to the product, the underwriters will need to make a “reasonable basis” determination – are the economics of the product suitable to at least some investors?

*Comparable indices:* it is always helpful to be able to compare the proposed proprietary index to other existing indices and to identify the differences between them. Although these comparisons need not always be included in the offering document, these comparisons will facilitate creating useful and informative index disclosure. These comparisons will also provide a useful perspective in thinking about listing the structured products—an index’s similarity to an existing index that has been the subject of a different listed structured product may facilitate the new listing.

*Licenses:* once a proprietary index is created, the index creator may want to provide licenses for its use. It will be helpful to have a form of license agreement and form disclosure regarding the license that may be used in a disclosure document.

*Third parties:* the index creator may contract with a third-party index sponsor who will be responsible for publication and dissemination of the index information, as well as with a calculation agent.

*Securities exchange:* if the issuer would like to list a structured product linked to the proprietary index on a securities exchange, it will be necessary to review the index and determine whether the index meets the criteria discussed in the relevant exchange's generic listing criteria for structured products. Alternatively, if the index is novel, listing will require a 19b-4 rule filing. The rule filing process may be quite time-consuming. In fact, it may require several months.

*Additional documents discussing the index:* the index sponsor may seek to create additional materials that describe the index. These may include brochures that explain the index to potential licensees, as well as documents that are intended to help market the relevant structured product. In each case, it will be necessary to ensure whether the disclosure is accurate, and whether, in the case of registered structured products, any of these materials need to be treated as a "free writing prospectus" under applicable SEC rules.

*Broad-based/narrow-based index:* the index creator also may focus on whether the proprietary index constitutes a broad-based index, which will be important to many investors.

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## When Is an Offering Completed? And Why Does It Matter?

An offering of structured products, like any other offering of securities, is deemed completed when the manager of the syndicate (if there is a syndicate) gives an all-sold notice. For many offerings of structured products, it is the broker-dealer affiliate of the issuer that is offering the structured products for sale to investors, either directly or through a network of distributors. Whether or not it is selling the securities of an affiliated issuer, a broker-dealer selling through distributors will need to obtain indications from the distributors that the distributors have sold their allocation and deem the offering completed.

As we have discussed briefly in a previous issue of [Structured Thoughts](#), for both the issuer and the underwriters, the completion of an offering is significant. An issuer will want to know that a particular offering has been completed for a number of legal and compliance reasons. The issuer will not want to be engaged in a continuous offering, or, if it is engaged in a continuous offering, then the issuer will want to monitor the progress of the offering in light of its own corporate events and any blackout periods arising in the ordinary course around earnings or special blackout periods. The issuer will find itself in a very uncomfortable position if there are unannounced material developments in its business which haven't yet been reflected in the documents incorporated by reference in the relevant prospectus.

The underwriter will want to ensure that it establishes a date on which the offering is deemed completed as well. First, the underwriter also may have a number of compliance concerns. For example, particularly for single stock or basket stock offerings, it will want to perform its internal window cleaning procedures in connection with the offering; if the offering is not immediately completed, the underwriter may need to continue to perform these procedures. As is the case for the issuer, the underwriter also will need to be mindful of the issuer's blackout periods. To the extent that the underwriter is taking into its inventory a portion of the offered securities for future resale, it will want to move those securities into a proprietary/investment account on the settlement date. For purposes of trade reporting through TRACE, the underwriter will need to demarcate between "primary" sales occurring as part of the offering and "secondary" sales occurring following completion of the initial offering. For purposes of disclosing the offering/sales price of the structured products in the TRACE system and on its own system, it will also be important to indicate which are primary sales and which are secondary sales.

As a result, for both the issuer and the underwriter, monitoring the completion of an offering is important.

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