

# Structured Thoughts

*News for the financial services community.*

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## **Additional SEC Guidance on Estimated Value Disclosures**

The Staff of the Division of Corporation Finance has provided additional guidance to a number of issuers relating to their structured note disclosures. Since the release of the SEC's "sweep letter" in April 2012,<sup>1</sup> market participants have been focused on revising their offering documents to address the issues raised in the letter. The new guidance relates to the portions of the sweep letter that have generated the most discussion, that is, the new requested disclosures relating to the "estimated initial value" of structured notes.

Elaborating on the sweep letter, the Staff noted that issuers must disclose the "issuer estimated value" on the cover page of the offering document, and share this information with investors prior to the time of sale. This estimated value should be based on the value of the "bond" element and the "derivative" element of the offered structured note. It seems that the Staff continues to think about a structured note as a "compound" security, comprised of two components. Disclosure documents should include a description of the estimated value, and any models used in the calculation of this amount. In calculating the value of the bond component, an issuer may use its internal funding rate or prevailing spreads. In discussing the value of the derivative component that has factored into the estimated value, the issuer should discuss any valuation models or assumptions.

As suggested by the sweep letter, and consistent with market practice, disclosure documents should include cautionary language, alerting investors that the estimated value will be lower than the issue price of the notes. The disclosures should address any risks inherent in the valuation or pricing of the bond or derivative components, including the use of any assumptions or internal models. The risk factors also should alert investors that there will not be a liquid secondary market for the securities, and that secondary market prices may be lower than the issue price.

<sup>1</sup> The sweep letter may be found on the SEC's website at the following link:  
<http://www.sec.gov/divisions/corpfin/guidance/structurednote0412.htm>.

Issuers also will want to review their disclosures relating to any secondary market in the notes to ensure that the disclosures explain whether the issuers or affiliated broker-dealers will or may make a market in the notes immediately following the initial sale, or for a period following the initial sale, and, if so, whether these activities are discretionary and involve any secondary market support.

This guidance is applicable to all issuers of structured notes, and we would expect that disclosures will be revised to address this guidance and to reflect emerging best practices. Of course, as we have all been reminded during recent months, each issuer and underwriter of structured notes has its own distinct business model, and a one-size-fits-all approach will not be appropriate. As a result, we anticipate that integrating many of these disclosure points and adapting disclosures to different issuance and distribution models will take some effort and careful thought.

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## FINRA to Continue Its Focus on Structured Products

FINRA's annual letter to member firms regarding its 2013 examination priorities contains a number of items relating to structured products.<sup>2</sup> The letter strongly suggests that structured products will remain an important focus for FINRA in the coming year. Many of the areas covered by the letter repeat recent FINRA pronouncements, which are noted below.

First on the list of FINRA's concerns, particularly in the area of sales to retail customers, is suitability and complex products.<sup>3</sup> FINRA reiterated that its revised suitability rule (FINRA Rule 2111) requires member firms and their registered representatives to have a reasonable basis to believe that a recommendation is suitable for a customer. FINRA restated its concern that member firms and their registered representatives fully understand complex products. Other concerns include potential failures to fully explain the risk-versus-return profile of certain products, and any disconnect between customer expectations and their risk tolerance.

FINRA stated its concern about products previously identified as "troublesome", which include structured products, exchange-traded funds (ETFs) and exchange-traded notes (ETNs). FINRA described structured products as "often complex" and having "cash flow characteristics and risk-adjusted rates of return that are uncertain or hard to estimate." In addition, the secondary market for structured products is limited.<sup>4</sup>

ETFs and ETNs, particular those employing leverage, are cited as potentially confusing to retail investors. FINRA also highlighted ETFs and ETNs linked to newly created index products with no established track record as areas of concern. Examples include index products linked to volatility, emerging markets and foreign currencies.<sup>5</sup>

For additional information relating to the examination priorities letter, please see our January 15, 2013 client alert, which may be found at the following link: <http://www.mofo.com/files/Uploads/Images/130115-FINRA-Early-Guidance.pdf>.

In 2013, member firms will need to continue to maintain and adhere to appropriate procedures and guidelines relating to sales of structured products.

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<sup>2</sup> The examination letter can be found at:

<http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p197649.pdf>.

<sup>3</sup> FINRA's most recent guidance on suitability (Regulatory Notice 12-55) can be found at:

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p197435.pdf>. We most recently discussed Regulatory Notice 12-55 in Volume 3, Issue 14, of Structured Thoughts, available at: <http://www.mofo.com/files/Uploads/Images/121218-Structured-Thoughts.pdf>.

<sup>4</sup> FINRA's most recent guidance on "complex products" (Regulatory Notice 12-03) can be found at:

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125397.pdf>.

We discussed Regulatory Notice 12-03 in Volume 3, Issue 1 of Structured Thoughts, available at:

<http://www.mofo.com/files/Uploads/Images/120119-Structured-Thoughts.pdf>.

<sup>5</sup> FINRA's Investor Alert on ETNs can be found at:

<http://www.finra.org/investors/protectyourself/investoralerts/tradingsecurities/p131262>. We discussed the ETN investor alert in Volume 3, Issue 10 of Structured Thoughts, available at: <http://www.mofo.com/files/Uploads/Images/120720-Structured-Thoughts.pdf>. FINRA also issued a FAQ on ETFs, which can be found at: <http://www.finra.org/Industry/Regulation/Guidance/P119781>. We discussed the ETF FAQ in Volume 1, Issue 1 of Structured Thoughts, available at: [http://www.mofo.com/files/Publication/d3eca515-40a4-4991-adfc-780d3a840532/Presentation/PublicationAttachment/5cab055d-f9d3-4a08-9bfe-d1cf7e9ec618/100112Structured\\_thoughts\\_newsletter\\_vol\\_1.pdf](http://www.mofo.com/files/Publication/d3eca515-40a4-4991-adfc-780d3a840532/Presentation/PublicationAttachment/5cab055d-f9d3-4a08-9bfe-d1cf7e9ec618/100112Structured_thoughts_newsletter_vol_1.pdf).

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## FINRA's Ketchum Discusses Structured Products

In a speech today to the SIFMA Compliance and Legal Society, Richard Ketchum, Chairman and Chief Executive Officer of FINRA, discussed the annual examination priorities letter. Topic number one was complex products, particularly structured products, ETFs and ETNs. Ketchum praised the industry for improving structured products disclosure documents, but tempered that praise by noting that the training of representatives with respect to such products often "falls through the cracks". FINRA is also concerned about "misleading" claims to investors about structured products.

Ketchum also discussed Regulatory Notice 12-55, FINRA's recent guidance on the suitability rule, which we discussed in Volume 3, Issue 14 of Structured Thoughts.<sup>6</sup>

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## FINRA Issues Q&A Guidance on New Communications Rules

FINRA's new offering communication rule, FINRA Rule 2210, will become effective on February 4, 2013.<sup>7</sup> Rule 2210 will, among other things, restructure FINRA's current communications categories and require that a variety of "retail communications" relating to registered structured products be filed with FINRA.<sup>8</sup>

In anticipation of the effective date, FINRA recently posted a set of questions and answers about Rule 2210. Several of these Q&As directly answer questions that have been asked by participants in the structured products market. The Q&A may be found on FINRA's website at the following link: <http://www.finra.org/Industry/Issues/Advertising/P197604>

### What Is a Structured Product?

FINRA refused to submit to the temptation to define "structured product" for purposes of the communications rules. Instead, FINRA recognized the impossibility of providing an exhaustive list, setting forth a few typical examples: exchange-traded notes, reverse convertibles, principal protection notes, and other that securities that include "embedded derivative-like features."

### Issuer-Prepared Communications

The Q&A confirms FINRA's position that the filing requirement is not intended to apply to issuer-prepared prospectuses, including issuer-prepared FWPs, that are filed with the SEC.

### Effect on Existing Communications Materials

A variety of market participants intend to continue to use brochures and other materials relating to structured products that were initially created before new Rule 2210 was adopted. These brokers have asked whether these materials would need to be filed under the new rule (if not previously filed), and FINRA has answered that question in the affirmative. Accordingly, underwriters should review the assortment of marketing materials that they plan to continue to use, and arrange for filing as needed. Of course, if they have not done so already, it would be useful to review these materials to ensure that they are consistent with FINRA's and the SEC's guidance as to these documents, and that they remain factually accurate.

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<sup>6</sup> Regulatory Notice 12-55 can be found at:

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p197435.pdf>. Our Structured Thoughts issue can be found at: <http://www.mofo.com/files/Uploads/Images/121218-Structured-Thoughts.pdf>.

<sup>7</sup> FINRA Rule 2210 (effective Feb. 4, 2013), available at:

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/industry/p127016.pdf>.

<sup>8</sup> We previously discussed the impact of the revisions on the structured product market in prior issues of Structured Thoughts, which may be accessed at the following links: <http://www.mofo.com/files/Uploads/Images/120119-Structured-Thoughts.pdf> and <http://www.mofo.com/files/Uploads/Images/110727-Structured-Thoughts.pdf>.

## Early Filing

Firms may wish to begin the filing process before the February 4<sup>th</sup> effective date. If they choose to do so, the materials will be reviewed under the content standards of existing NASD Rule 2210, as opposed to the new rules. However, the content standards of new Rule 2210 would apply if the materials are used after the effective date.

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## **FINRA Proposal Requires Disclosure of Enhanced Compensation**

Continuing ongoing efforts to address conflicts of interest in the financial services industry,<sup>9</sup> FINRA requested comments on a Proposed Rule requiring disclosure of conflicts of interest relating to recruitment compensation practices.<sup>10</sup> The Proposed Rule addresses concerns that recruitment incentives could motivate financial advisors to churn customer accounts and to make unsuitable investment recommendations.<sup>11</sup>

Under the Proposed Rule, when a registered person receives “enhanced compensation” in connection with recruitment to a member firm, the recruiting firm would have to provide details of that compensation to the registered person’s prior customers before taking their accounts. The Proposed Rule defines enhanced compensation broadly to include any “signing bonuses, upfront or back-ended bonuses, loans, accelerated payouts, transition assistance, and similar arrangements, paid in connection with the transfer of securities employment....”<sup>12</sup>

In these cases, a financial advisor may have an economic incentive both to bring the accounts of his or her former employer to the new firm, and to generate trading activity in the account once it was moved. Any of these steps may or may not be in the best interest of the relevant customers.

The Proposed Rule would require the recruiting firm to disclose details of enhanced compensation “at the time of first individualized contact by the recruiting member or registered person with the former customer after the registered person has terminated his or her association with the previous firm.”<sup>13</sup> If the disclosure is made orally, or if a former customer seeks to transfer an account without prior contact from the financial advisor or the recruiting firm, the firm would have to include a written disclosure in the account transfer approval documentation.<sup>14</sup> A written disclosure must be “clear and prominent” and must contain specific details about the enhanced compensation, such as timing, amount, and nature of the arrangement.<sup>15</sup> The Proposed Rule would require disclosure for one year following the date that the registered person joins the firm.<sup>16</sup> However, the disclosure requirement would not apply to enhanced compensation below \$50,000 or to customer accounts that are “institutional accounts” under FINRA Rule 4512(c).<sup>17</sup>

FINRA has requested comments on the Proposed Rule, and the comment period expires on March 5, 2013.<sup>18</sup>

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<sup>9</sup> See <http://www.mofo.com/files/Uploads/Images/120814-FINRA-Conflicts-of-Interest.pdf>. See also Dodd-Frank, Section 913 (requiring the SEC to “facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest,” and to issue rules where appropriate to “[prohibit] or [restrict] certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers and investment advisers....”).

<sup>10</sup> FINRA Regulatory Notice 13-02, January 2013,

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p197599.pdf>.

<sup>11</sup> Open Letter to Broker-Dealer CEOs from former SEC Chairman Mary L. Schapiro, dated August 31, 2009,

<http://www.sec.gov/news/press/2009/2009-189-letter.pdf>.

<sup>12</sup> The Proposed Rule is available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/industry/p197601.pdf>.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> FINRA Regulatory Notice 13-02, January 2013,

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p197599.pdf>.

<sup>16</sup> The Proposed Rule is available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/industry/p197601.pdf>.

<sup>17</sup> *Id.*

<sup>18</sup> FINRA Regulatory Notice 13-02, January 2013,

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p197599.pdf>.

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## MoFo Capital Markets Introduces Structured Product Resource Page

By popular demand of our clients and other market participants, our capital markets website now includes a page containing links to key legal resources relating to structured products.

The page may be found at the following link: <http://www.mofo.com/resources/structured-products/>.

The page includes links to a wide variety of frequently-used reference materials, including:

- FINRA's releases relating to structured products.
- FINRA's enforcement proceedings relating to structured products.
- SEC materials relating to structured products.
- Back-issues of this venerable publication.
- And more.

We hope these materials will help you navigate the evolving legal landscape for structured products.

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For more updates, follow Thinkingcapmarkets, our Twitter feed: [www.twitter.com/Thinkingcapmkt](http://www.twitter.com/Thinkingcapmkt).

Morrison & Foerster named **Structured Products Firm of the Year, Americas, 2012** by *Structured Products* magazine for the fifth time in the last seven years. See the write up at <http://www.mofo.com/files/Uploads/Images/120530-Americas-Awards.pdf>.

Morrison & Foerster named **Best Law Firm of the Americas, 2012** by *StructuredRetailProducts.com*.

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