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Structured Thoughts

News for the financial services community.

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"Structured Products, Meet the Volcker Rule": The New Limitations on Proprietary Trading

Introduction

As readers of this publication know, the long-anticipated final Volcker Rule has been issued. The rule generally prohibits, among other things, any "banking entity" from engaging in "proprietary trading" with respect to a wide variety of financial instruments.

For our firm's more detailed discussion of the rule, please see our "User's Guide to the Volcker Rule" (the "User's Guide"), which may be found at: http://www.mofo.com/files/Uploads/Images/131223-A-Users-Guide-to-The-Volcker-Rule.pdf.[1] We will not repeat all of the information in that guide here. Instead, in this article, we discuss the principal expected impact of the rule on issuers and underwriters of structured products. In particular, we examine the rule's exemptions for market-making activities, underwriting and hedging activities. In addition to proprietary trading activities, we also will examine how the final rule's provisions relating to "covered funds" are likely to impact certain types of structured products.

Banking Entities – Affected Parties in the Structured Products Markets (Not Just Banks)

The final rules do not apply simply to "banks." Rather, the rule's prohibitions apply to a larger group of so-called "banking entities." These entities include:

- insured depository institutions;

[1] See also our client alert, "The Volcker Rule and Capital Markets Offerings," which may be accessed at: http://www.mofo.com/files/Uploads/Images/131227-Volcker-Rule-Capital-Markets-Offerings.pdf.

- any company that controls an insured depository institution;
- any foreign entity that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978 (i.e., because it has a U.S. branch or agency);[2] and
- any affiliate or subsidiary of any of those entities.

The broad final bullet above brings the broker-dealer affiliates of banks within the scope of the new rule. These entities, of course, are involved in a variety of features of the structured products market, including structuring, underwriting, trading and hedging. In contrast, broker-dealers that are not affiliated with banks, which sometimes act as key distributors of structured products, would be outside the scope of the new rules.

Broad Prohibition of Proprietary Trading

Definition. The final rule prohibits a banking entity from engaging in “proprietary trading.” Proprietary trading is defined as “engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments.”

Exemptions. Because of the potentially broad reach of this prohibition, the rule contains detailed exemptions. These exemptions are intended to balance the need to reduce the risks relating to large financial institutions, while enabling these entities to continue many of their existing roles in the financial sector. In the area of structured products, the ones of principal importance are for market-making activities, underwriting and hedging, as discussed in more detail below.

The Backstop Provisions. However, even if otherwise permitted by the exemptions, proprietary trading activities by a banking entity are subject to additional provisions and restrictions under the final rule. These restrictions are described below in “The Backstop Provisions – Exceptions to the Exemptions.” Structured products raise a variety of issues under the backstop provisions.

Transactions Within (and Outside) the Prohibition. The ban relates to trading for the banking entity’s own account. As a result, a wide variety of transactions that occur in the structured products market are not affected. For example, transactions in which a financial institution acts on an agency basis for a client, or acts as a riskless principal for a non-affiliated entity, would not be prohibited by the new rules.

Note that the prohibition relates to “financial instruments,” which are defined as:

- securities (including options on securities);
- derivatives (including options on derivatives); and
- contracts of sale of a commodity for future delivery (or options on those contracts).

The majority of structured products issued today would fall into the first category, “securities.” However, most structured certificates of deposit, which are intentionally structured not to be “securities,” would appear to be exempt from the prohibition.[3]

[2] For a discussion of the final rule’s impact on certain off-shore transactions by non-U.S. entities, please see our client alert: “The Volcker Rule: Impact of the Final Rule on Foreign Banking Organizations,” which may be accessed at http://www.mofo.com/files/Uploads/Images/131211-Volcker-Rule.pdf.
[3] See the discussion in our “Frequently Asked Questions About Structured Certificates of Deposit,” available at: http://www.mofo.com/files/Uploads/Images/Frequently-Asked-Questions-about-Structured-Certificates-of-Deposit.pdf.

Market-Making Exemption

General. The final rule is designed to permit a broad scope of market-making activities, while prohibiting impermissible proprietary trading that may pose significant risk to the financial system. The final rules provide flexibility for market-making activities generally, but also limit those activities through a mix of compliance requirements and risk controls. Banking entities will be permitted to determine the appropriate scope of their market-making activities based on the liquidity, maturity and depth of the relevant markets. Banking entities will need to analyze their activities in terms of the overall exposures and market-making inventory held by their different trading desks.

Scope of the Exemption. The rule permits "the purchase, sale, acquisition, or disposition" of financial instruments "in connection with market-making related activities, to the extent that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties."

Criteria for Market-Making. Market-making activities are permitted for a particular "trading desk"[4] if the trading desk satisfies six criteria:

- It "routinely stands ready" and is "willing and available" to trade the relevant instruments.
    - This provision contemplates that the standards will differ somewhat among different asset classes and financial instruments. For example, a commodity-linked structured note does not have the same type of market as a share of Apple common stock. Even willingness to "trade by appointment" in an illiquid security can qualify under the rule. However, a trading desk would need to demonstrate a pattern of effecting transactions in response to demand from its customers. Broker-dealers may face a challenge of making this case in connection with illiquid types of structured products.

- It has a "market-maker inventory" that is designed not to exceed the reasonably expected near-term demand of customers, clients and counterparties.
    - In the area of structured products, where the primary distribution of the instrument tends to exceed the distribution in the secondary market, the appropriate inventory may be relatively less than is the case for other types of instruments.
    - This inventory test will depend in part upon the liquidity, maturity and depth of the relevant market. It must be based on a "demonstrable analysis" of indicators of near-term customer demand that include (i) historical levels of demand, (ii) expectations based on market factors and (iii) current demand. For complex structured products, "demonstrable analysis" means that the trading desk needs to have "prior express interest" from customers in the "specific risk exposures" of the instrument prior to holding an instrument to engage in market-making activity.
    - In less mature markets, as is the case for many new structured products, it may be more difficult to predict near-term customer demand. In these cases, to determine near-term customer demand, the adopting release recommends that banking entities will use historical data from similar products, reasonably expected future demand that is determined based on customer relationships, or other relevant factors.
    - The final release states that a trading desk creating a structured product that is not based on any customer demand, and then soliciting customers to trade the instrument during or after its creation, would not satisfy this provision.

[4] A "trading desk" is "the smallest discrete unit of the organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof." The final rule contemplates that a trading desk will be managed and operated as an individual unit, and reflect the level at which the profit and loss of market-making traders will be attributed.

- The banking entity must maintain an internal compliance program that includes “risk limits” on the trading desk's “market-maker inventory” and “financial exposure,” as discussed in the User’s Guide. We would note that the compliance program must identify how the banking entity hedges the risks associated with its market-making activities, for example, when the entity obtains additional exposures to different types of underlying assets as a result of its purchase of structured products in market-making transactions. These hedging activities related to its market-marking activities must comply with the market-making exemption, and not with the hedging exemption discussed below.

- If a risk limit is exceeded, the trading desk must promptly take action to restore adherence to the limits.

  - In the case of structured notes, this may result at times in a broker-dealer requesting the affiliated or unaffiliated issuer of the note to repurchase and cancel the note at an agreed price.

- The banking entity must have compensation requirements for its traders that are not designed to reward or incentivize prohibited proprietary trading.

- The banking entity must be appropriately licensed or registered to engage in the market-making activity.

Underwriting Exemption

General. The final rule enables banking entities to structure their underwriting activities based on the nature of the relevant securities. The exemption includes a broad range of both registered and exempt offerings.

Scope of Exemption. Generally, a banking entity must meet five tests to satisfy the underwriting exemption:

- The banking entity must act as an underwriter for a distribution of securities, and the trading desk's underwriting position must be related to that distribution.

  - The rule indicates that for purposes of this definition, a “selling group member” that is not in privity of contract with the issuer can be an “underwriter.”

  - Participation in an exempt offering, such as a Rule 144A or bank note offering, can qualify as an “underwriting.”

  - The rule is largely focused on traditional underwritings in connection with capital raising transactions. However, according to the adopting release and the rule’s definition of a distribution, an underwriter’s role in connection with a “reverse inquiry” transaction, such as those used for many structured note offerings, will typically qualify for the exemption, subject to the discussion below about the underwriter not purchasing more than it can expect to distribute in the near-term.

  - According to the adopting release, a trading desk would not be able to use the underwriting exemption to purchase a financial instrument from a customer to enable the customer to buy securities in the distribution. This restriction suggests that, for example, a broker-dealer’s arrangement of a “pre-borrow” in a security may not be permitted, nor may the broker-dealer necessarily facilitate a hedge in a related security in advance of or in connection with a distribution. However, in some cases, another exemption may be available for these types of transactions, such as the market-making exemption. For example, the underwriter may be able to repurchase a security in which it makes a market in accordance with the new rules in order to enable a customer to purchase a security that is subject to the distribution.

- The composition of the securities in the underwriting position must be designed not to exceed the reasonably expected near-term customer demand, and reasonable efforts must be made to sell or reduce the position in a reasonable time (taking into consideration the liquidity, maturity, and depth of the market for the relevant type of security).

- This provision may have the effect of limiting a practice used at times in the structured products sector – an underwriter holding "inventory" to address future demand, particularly where there isn't necessarily a historic interest in purchasing the relevant type of instrument from the underwriter's inventory. The practice of holding a security in a "freezer" account (or an "investment account") may be incompatible with the notion that the broker-dealer is attempting to continue the offering and to reduce the position.

- In contrast, the rule recognizes that an underwriter may at times hold an unsold allotment when market conditions make it impracticable to sell the entire allotment at a reasonable price at the time of the distribution, and that it may sell that position when it is practicable to do so.

- The provision may increase the likelihood that broker-dealers will size a structured note offering in accordance with the extent of actual orders, instead of adding an additional allotment to address potential orders after the pricing date.

- The banking entity must establish, implement, maintain and enforce an internal compliance program that identifies and addresses, among other items, position limits, internal controls, escalation procedures, and independent testing, as discussed in the User's Guide.

- The compensation arrangements for employees on the trading desk must not incentivize impermissible proprietary trading.

- The banking entity must be appropriately licensed or registered to engage in underwriting activity, where required.

Risk-Mitigating Hedging Exemption

General. The final rule confirms that hedging transactions related to both individual or aggregated positions, including "dynamic hedging" and "anticipatory hedging," are permitted. However, the final rule imposes enhanced documentation and compliance requirements upon banking entities that do so.

Scope of Exemption. The rule requires the establishment of an internal compliance program of policies and procedures to ensure compliance with the requirements of the hedging exemption, as discussed in the User's Guide. These procedures will likely require input from a wide range of trading desks, to ensure that their activities fit within the scope of the banking entity's policies. Structured products trading desks will seek to have a "seat at the table" to ensure that their needs are appropriately reflected.

For brokers hedging structured products, we note that the final rule expanded the hedging exception somewhat by removing a requirement in the proposed rule that an anticipatory hedge be established "slightly" before the banking entity becomes exposed to the specific, identifiable risk.

We anticipate that significant attention will be required among banking entities over the next several months to ensure the creation of policies and procedures that will comply with the rules.

The Backstop Provisions – The Exceptions to the Exemptions

Even if a transaction is permitted by the final rules under one of the exemptions described above, proprietary trading activities remain subject to the so-called "backstop provisions" of the Volcker rule. That is, otherwise permitted activities will be prohibited if they:

- Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties.

    - Under the final rules, the mere fact that a buyer and seller (for example, an underwriter and an investor) are on opposite sides of a transaction and have differing economic interests would not be deemed a "material" conflict of interest. However, the existence of a material conflict of interest depends on the specific facts and circumstances, and the structured product area remains one that is rife with these types of conflicts.[5]

- Conflicts of interest can be mitigated under the final rules through either (a) timely and effective disclosure or (b) information barriers. The disclosures must permit a reasonable client, customer, or counterparty to understand the conflict in a meaningful way and substantially mitigate or negate any materially adverse effect created by the conflict.[6] Disclosures must be provided sufficiently close in time to the customer's investment decision to allow for meaningful understanding and mitigation action. In the case of structured products sold to retail investors, this will further the importance of providing an investor with robust disclosures, often in the relevant structured product offering documents, as to the relevant product and any embedded conflicts.

- If the banking entity addresses the conflict through information barriers, it must establish, maintain and enforce barriers reasonably designed to avoid a conflict's materially adverse effect, through written policies and procedures, physical separation, functional separation and limitations on types of activities conducted. These types of features are typically already in place in banking entities with affiliated broker-dealers. However, notwithstanding the establishment of information barriers, the banking entity may not rely on these information barriers if it knows or should reasonably know that a material conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty. In these types of situations, the banking entity must address the conflict through the types of timely and effective disclosures described in the preceding bullet.

- Result in a material exposure by the banking entity to a high-risk asset or trading strategy.

  - A high-risk asset or trading strategy is defined as an asset or trading strategy that would significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the U.S. Accordingly, even though many structured products are "high risk" in the conventional sense, their individual or aggregate transaction amounts may not be deemed "high risk" for purposes of this test. For example, many "risky" structured products may be issued or hedged in amounts that are immaterial to the institutional as a whole. Of course, any particular transaction or series of transactions must be independently evaluated.

- Pose a threat to the banking entity's safety and soundness or to the financial stability of the U.S.

Structured Products and Covered Funds

In addition to the new proprietary trading restrictions, market participants will also want to consider the second prong of the Volcker Rule – the prohibition on acquiring or retaining ownership interests in, or acting as sponsors to, "covered funds."

Some issuers and their affiliated broker-dealers act from time to time as the sponsor or depositor of trust vehicles that are used to issue structured products or to "repackage" debt securities. These vehicles may be "covered funds." The final rule provides for a number of specific exceptions from the definition of covered fund, such as the exceptions for traditional securitizations (as discussed in our client alert, "The Volcker Rule: Impact of the Final Rule on Securitization Investors and Sponsors"[7]); however, there may not be an available exception for these types of structured product vehicles. As a result,

[5] See our article, "FINRA's Report on Conflicts of Interest: Issues for the Structured Products Market" http://www.mofo.com/files/Uploads/Images/131015-Structured-Thoughts.pdf.
[6] For structured product offerings, we believe it is possible in most cases to create disclosures that enable a customer to understand the conflict. However, in the case of embedded conflicts of interest, it is often less likely that a customer can "mitigate or negate" a conflict in any manner other than not to effect the transaction in light of the available information.
[7] Available at: http://www.mofo.com/files/Uploads/Images/131226-Volcker-Rule-Impact.pdf.

issuers that are banking entities should consider whether any of their existing or planned vehicles would be impacted by the final rule.

Unless a special purpose entity fits within one of the exclusions from the covered fund definition, the issuer will be a "covered fund" if it:

- would be an investment company under the Investment Company Act of 1940, as amended (the "1940 Act"), but for the exemptions set forth in Section 3(c)(1) or 3(c)(7) of the 1940 Act;
- is a commodity pool for which the commodity pool operator ("CPO") has claimed exempt status under the regulations of the Commodity Futures Trading Commission ("CFTC") or that could qualify as such an exempt pool and that satisfies certain other criteria; or
- is a foreign issuer that is sponsored by, or which has an ownership interest held by, a U.S. banking entity or one of its affiliates, and that would be an investment company but for Section 3(c)(1) or 3(c)(7) of the 1940 Act if its securities were offered to U.S. residents (subject to certain exceptions).

Generally, most special purpose entities established to serve as repackaging vehicles or to issue structured products rely on the Section 3(c)(1) or 3(c)(7) exemption from the 1940 Act. If a special purpose vehicle relied on Section 3(c)(1) or 3(c)(7), it may not be a covered fund if another 1940 Act exemption is also available. Certain special purpose entities that were established after the enactment of the Dodd-Frank Act may be CPOs were it not for reliance on the de minimis exception. There are various exclusions available (i.e., there are exclusions for loan securitizations, qualifying ABCP conduits, qualifying covered bonds, and wholly owned subsidiaries); however, most of the exclusions would not be relevant to these types of special purpose entities. Generally, exclusions are not available for special purpose entities that hold securities and derivatives rather than loans.

Conclusion

Activities of participants in the structured products market will be affected in a variety of ways as a result of the Volcker rule's implementation. At this stage, it is of vital importance that the trading desks of the relevant entities be involved in their institutions' planning of their new operations, policies and procedures. They will need to ensure that, to the extent possible, their trading activities can be successfully fit into the institution's overall compliance plans.

A variety of interpretative questions has already arisen, and will continue to arise prior to the effective dates of the new rules. Market participants will continue to monitor the interpretations and statements of the financial regulators, in order to help ensure their compliance with the new regime.

SEC and FINRA Personnel Speak at Structured Products Conference

In December 2013, *Structured Products* magazine hosted a regulatory and compliance conference in Washington, D.C. The panels included representatives of the SEC and FINRA, including the SEC's Division of Corporation Finance Office of Capital Markets Trends, Office of Compliance Inspections and Examinations and Division of Enforcement, and FINRA's Division of Enforcement and Advertising Regulation Department.

The agenda for the conference, and the identities and offices of the presenters, may be found at the following link: http://www.structuredproductswashington.com/static/agenda.

The panels provided useful reminders of some of the regulators' view on a variety of current issues that the industry faces.

Office of Capital Market Trends

The conference began with a presentation by Amy Starr, the head of the SEC's Office of Capital Market Trends, about the new estimated value disclosures, among other topics. Ms. Starr summarized the process in which the SEC issued its "sweep letter," reviewed responses and followed up with issuers. She reported that she and other members of her team found the interactions successful in that they worked closely with market participants and received a significant amount of information about the structured products market and its operations. Her office is generally pleased with the new disclosures that they are seeing. Going forward, in conducting their periodic reviews of filings by bank issuers, SEC staff members may comment on the estimated value disclosures, working together with members of the Office of Capital Markets Trends.

Future areas of focus for Ms. Starr's group may include exchange traded notes. Such a review could include, for example, a review of whether and how the new estimated value disclosures relate to this product class, and the relationship that any estimated values, indicative values and trading values have to one another. In addition, she indicated that potentially misleading product names remain a concern.

Ms. Starr emphasized the importance of having understandable disclosures, particularly on the cover page and the summary section of the prospectus. She reminded the audience that the U.S. is a disclosure-based regime, and that the SEC does not have any objection to any particular product, provided that its terms and risks are adequately disclosed. When retail investors are expected to participate in product offerings, extra efforts should be made to ensure that the disclosures are understandable.

FINRA Regulation

Consistent with recent FINRA regulatory notices, these panelists indicated that FINRA would continue to review policies to address complex products and conflicts of interest. Tom Selman of FINRA noted FINRA's ongoing concern that registered representatives may not always be able to simply explain, through a diagram or otherwise, the potential performance of a product under different market conditions. The regulators on the panel expressed some concerns about complex indices, and noted that those may not be well understood by distributors. FINRA indicated that it has intentionally not defined what types of products must be considered "complex," as any definition would need to evolve over time, and could result in creative drafting efforts designed solely to avoid the definition. Instead, when in doubt, broker-dealers should generally err on the side of classifying a product as "complex."

FINRA Advertising Department

Representatives of the FINRA Advertising Department summarized the recent changes to FINRA's communication rules and how they apply to a variety of offering documents. Dave Roscum, manager of FINRA's Advertising Regulation Department, reminded the audience that brokers need to consider the impact of the new approval and filing rules on a wide range of documents, electronic messages, print ads, and, in some cases, even materials that are labelled "for broker use only," if their distribution is not properly restricted.

Panelists described several practices that they recommended relating to structured product marketing materials that they had reviewed, such as making sure that performance graphs are understandable. They indicated that since the effective date of the new communications rules, FINRA has received over 800 submissions for review, and issued comments to the submitting brokers on approximately 80% of the submissions, which they believed required revisions. FINRA believes that there has been a gradual improvement in the quality of these documents. In its reviews, FINRA focused on the following issues:

- Whether the disclosures are fair and balanced.
- Whether the disclosures indicate how a product will perform in a variety of market conditions.
- The potential value and liquidity (or lack thereof) for a product.

FINRA expects disclosures to indicate, where applicable, that the product is not suitable for all investors, and to include appropriate detailed risk factors and a discussion of product fees and expenses. Unlike the SEC's view that multiple documents work together to form a "disclosure package" (such as when a Form 8-K with recent financial information is read together with a short form prospectus supplement), FINRA believes that each marketing document must be sufficient in and of itself, without excessive reliance on the "statutory prospectus."

The following practices were identified as potential "no-no's":

- Overstating the liquidity of a product.
- Describing a product as providing "steady returns."
- Setting forth misleading performance information.
- Stating that a product is "safe."
- Glossing over risks or complexity.

FINRA's representatives on the panel repeated some of its prior guidance that FINRA does not currently accept filings of individual "templates" of different types of documents, such as offering term sheets or summaries. Rather, each relevant document, even when describing an offering that is similar to one that has been previously filed, needs to be refiled with FINRA. However, it was noted that, in the future, FINRA may consider a system for filing some types of structured note templates. In addition, Mr. Roscum reminded the audience that documents that were used after the effective date of the rules, even if they were first introduced before the effective date, are not exempt from the filing requirement.

FINRA's panelists repeated its prior guidance that they do not believe that hypothetical backtested data for indices is appropriate for inclusion in broker marketing materials.

How Much Are Structured Notes Worth?

Richard Vagnoni, senior economist of FINRA, delivered a presentation entitled "Structured Retail Products: View from an Economist." During his presentation, Mr. Vagnoni cited academic and other research which contained at times inconsistent conclusions as to the value of structured products as compared to other investments, and the extent to which offering documents set forth potential scenarios that are too positive, or too negative. These are debates that may continue over the next several years.

SEC Enforcement/FINRA Enforcement

SEC and FINRA participants stated that not every examination finding of a deficiency is referred to their enforcement departments; a decision to make a referral depends on a variety of factors. For example, a bona fide effort by a broker-dealer to correct any improper activities (or inactions) could reduce the likelihood of enforcement proceedings. FINRA noted that the relationship between any deficiency and any broader systemic conduct would be taken into consideration; in particular, there would be a greater likelihood of an enforcement referral if a specific incidence of a problematic sales practice or disclosure could be traced to a deficiency in the firm's supervisory policies or procedures. On the other hand, a self-discovery and self-correction, and self-reporting, along with cooperation with the regulators, might help a firm avoid formal action.

Exams are likely to focus on conflicts of interest in the coming year. The FINRA enforcement representative indicated that FINRA's recent report on conflicts of interest has created a "vocabulary" that will help guide the examination program's review of product sales.

Another question that comes up in exams is how a broker gained access to structured products. If a firm is in a distribution channel with access to structured products, the firm's management must vet the products to avoid any suitability problems. In some cases, brokers will be asked to explain how retail investors gained access to certain types of products, and what types of procedures were applied to govern those sales efforts.

The panelists discussed the benefits of "know your distributor" policies and practices, among other topics. Future FINRA examinations are expected to focus to a greater degree on these procedures.

Conclusion

A recurring theme at the conference was the importance of communications between the regulators and the industry, and the efforts of the SEC and FINRA to understand developments in the structured products market. We expect these communications and efforts to continue.

FINRA's Annual Regulatory and Examination Priorities: Structured Products Remain an Area of Focus

On January 2, 2014, FINRA issued its annual regulatory and examination priorities letter. (http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p419710.pdf)

Perhaps not surprisingly to readers of this publication, structured products remain an area of FINRA focus.

In particular, the letter states, with reference to "complex structured products": "These products represent a risk to retail investors who do not fully understand the credit risk exposure they are taking (i.e., these are unsecured investments), the illiquidity of those investments, the derivative features that may be embedded in some products, and the uncertainty around the valuation of these products and their associated cash flows. The use of leverage in some products can potentially exacerbate exposure to loss and index tracking error; such is the case with leveraged exchange traded funds (ETF)."

The letter also references a number of additional focus areas that often involve structured products, including:

- Suitability (including the suitability of debt instruments that are sensitive to changes in interest rates);
- Conflicts of interest.
- Due diligence and suitability of private placements.
- Broker-dealer sales to senior investors.

For additional discussion of the annual letter, please see our client alert, "A Must Read: FINRA's 2014 Exam Priorities": http://www.mofo.com/files/Uploads/Images/140103-FINRA-2014-Exam-Priorities.pdf.

FINRA Reiterates Its Concern about Unsuitable Sales of Non-Traditional ETFs

FINRA recently announced a disciplinary proceeding that underscores its continuing concerns about unsuitable retail sales of structured products. In a recently settled formal disciplinary proceeding, FINRA censured a registered broker-dealer and ordered it to pay restitution to customers and others who lost money trading in, among other things, non-traditional exchange-traded funds (ETFs).

FINRA's action relates to sales of leveraged ETFs (which deliver a daily return based on multiples of the performance of a benchmark or index), inverse ETFs (which deliver the opposite of the daily performance of a specific benchmark or index), and ETFs that are both inverse and leveraged. A daily "reset" feature of such non-traditional ETFs means that these products are designed to meet their objective only on a daily basis. As a result, their performance over time may differ significantly from the performance of the underlying index or benchmark. This effect can be magnified in volatile markets.

The order notes the growth in popularity of non-traditional ETFs after 2006, and finds that the sales at issue occurred between January 2008 and August 2009. FINRA found that the broker-dealer firm failed to establish and maintain a supervisory system and written procedures reasonably designed to monitor transactions in non-traditional ETFs. Rather, FINRA said that the firm monitored non-traditional ETFs in the same way that it monitored traditional ETFs until FINRA issued a Regulatory Notice regarding non-traditional ETFs in 2009, and failed to take into consideration, for example, risks associated with longer-term holding periods. FINRA also found that the firm failed to provide adequate formal training to its brokers and supervisors regarding the features, risks and characteristics of non-traditional ETFs until after FINRA issued its Regulatory Notice.

FINRA found that the firm failed to satisfy its reasonable-basis suitability obligation by allowing its brokers to recommend the non-traditional ETFs without performing reasonable diligence to understand the risks and features of the products. FINRA also found that the firm failed to determine customer-specific suitability for at least 27 customers who lost money. The products were unsuitable, FINRA found, because they were held in those customers' accounts for extended time periods, subjecting the customers to the effect of compounding and daily resets.

FINRA also found that certain of the firm's registered representatives engaged in a pattern of unsuitable mutual fund switching and that it failed to maintain adequate supervisory procedures designed to prevent such switching.

IOSCO Issues Final Toolkit

Introduction

In December 2013, the International Organization of Securities Commissions ("IOSCO") issued its final report, setting forth its regulatory toolkit.[8] The toolkit outlines a variety of regulatory options that IOSCO members may find useful in determining their regulation of retail structured products. None of the potential regulatory measures are mandatory, and IOSCO recognizes that some or all may not be appropriate for every regulatory structure.

The final report arises from IOSCO's consultation released in April 2013,[9] which we discussed in detail in a prior issue of this publication.[10]

Scope of the Final Report

The final toolkit does not vary significantly from the toolkit set forth in the consultation, although it includes some clarification based upon responses to the consultation.

The toolkit is divided into five principal sections, each of which represents an aspect of the structured products market that may be regulated.

- Potential overall regulatory approach.
- Potential regulation of the design and issuance of the products.
- Potential regulation of the disclosure and marketing of the products.
- Potential regulation of the distribution of the products.
- Potential regulation of the post-sales practices.

(Each category begins with the word "potential," again, because regulators remain free to determine the scope of regulation that is appropriate to their respective jurisdictions.)

Responses to the Consultation

IOSCO received 28 responses to its consultation report. Commentators ranged from governmental agencies, to stock exchanges, to banks, to individuals. A few responses to the consultation may be of interest:

- *Regulatory Pre-Approvals for Products.* Fifteen of 20 respondents did not think that regulators should play a role in setting product standards for retail structured products "because it is morally hazardous, will reduce product innovation and hinder competition." Instead, these respondents favored a disclosure-based regulatory system.
- *Short Form Disclosures.* There was support from all respondents to this issue (22) for short-form or summary disclosure with a clear key information disclosure document. Of course, many market participants differ as to the appropriate scope of such a document, and the extent to which they should permit comparisons among different products.
- *Estimated Value Disclosure*. Twelve respondents (of 19) to this issue did not agree with disclosing the estimated fair value of a retail structured product at the time of issuance, since they believe this would not be helpful to investors. These respondents stated that the calculations models used by issuers differ, and the subjective values embedded in the models are therefore not comparable.

[8] The report may be found at the following link: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD434.pdf.
[9] The consultation may be found at the following link: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD410.pdf.
[10] See http://www.mofo.com/files/Uploads/Images/130502-Structured-Thoughts.pdf.

- *Disaggregated Costs*. On a related point, there were mixed views on whether the disclosure of disaggregated costs should be made public, or exchanged between the issuer and distributor or IOSCO member. Eleven of 23 were against such disclosures. Respondents who opposed these disclosures believed that they are difficult to understand and irrelevant (according to two respondents) or not useful (according to other opposing respondents) for retail investors.

- *Responsibility for Third-Party Distributors*. Fifteen of 18 respondents did not believe that it would be appropriate for IOSCO members to require or encourage issuers to have more responsibility for the actions of distributors that distribute their products.

Conclusion

The IOSCO report reiterates a variety of options that remain available to international regulators. Of course, many of these tools have been implemented in a number of key markets for structured products. As different jurisdictions continue to implement their own regulatory approaches, market participants may have the opportunity to observe which approaches prove to be most helpful to investors.

Michael Osnato Named by SEC to Lead the Enforcement Division's Complex Financial Instruments Unit

The SEC announced on January 6 that Michael J. Osnato, Jr. will lead the Complex Financial Instruments Unit. The unit is comprised of attorneys and industry experts working in SEC offices across the country to investigate potential misconduct related to asset-backed securities, derivatives and other complex financial products. The unit was formerly known as the Structured and New Products Unit. The SEC's announcement can be found at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540590596.

LinkedIn

We have created a LinkedIn group, StructuredThoughts. The group will serve as a central resource for all things Structured Thoughts. For example, we have posted on the page all back issues of Structured Thoughts. From time to time, we will be disseminating news updates through the LinkedIn group. For updates, we invite you to join the group: http://www.linkedin.com/groups/StructuredThoughts-6547296?home=&gid=6547296&trk=anet_ug_hm.

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

Morrison & Foerster named Structured Products Firm of the Year, Americas, 2012 by *Structured Products* magazine for the fifth time in the last eight 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 by *StructuredRetailProducts.com*.

Morrison & Foerster named Legal Leader, 2013 by *mtn-i* at their Americas Awards. Two of our 2012 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 their 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 10 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.

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.