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Structured Thoughts

News for the financial services community.

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FINRA Requests Comments on Proposed Amendments to Rule 2210 and Issues Additional FAQs

In May 2015, FINRA issued Regulatory Notices 15-16 and 15-17, both relating to Rule 2210, Communications with the Public. The notices are a result of FINRA's retrospective review of Rule 2210.[1] Notice 15-16 contains a number of proposed amendments to Rule 2210.[2] Notice 15-17 provides additional guidance, in the form of nine new Rule 2210 FAQs.[3] The proposed amendments and the new FAQs cover a number of areas, a few of which are of particular interest to member firms selling structured products.

Proposed Amendments Designed to Broaden Exclusions from the Filing Requirements

Current Rule 2210(c)(1)(A) requires new member firms to file with the FINRA advertising department any retail publication that is published or used in any electronic or other media at least 10 business days prior to first use. A proposed amendment responds to concerns that FINRA reviews of member firms' websites unnecessarily delay firms' abilities to communicate with the public, without providing any counterbalancing investor benefit. The proposed amendment would

[1] We discussed the Rule 2210 retrospective review in Vol. 5, Issue 9 of Structured Thoughts, available at: http://www.mofo.com/~/media/Files/Newsletter/2014/12/141223StructuredThoughts.pdf. In FINRA's retrospective review report, FINRA stated that they would "explore a combination of guidance and proposed rule modifications and administrative measures … to enhance the effectiveness and efficiency of the rules." See the FINRA Retrospective Rule Review Report, Communications with the Public (Dec. 2014), available at: http://www.finra.org/sites/default/files/p602011.pdf.

[2] Regulatory Notice 15-16 (May 18, 2015) can be found at: http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory_Notice_15-16.pdf.

[3] Regulatory Notice 15-17 (May 22, 1015) can be found at: http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory_Notice_15-17.pdf.

require the filing of a firm's website and material changes to the website within 10 business days after first use during the one-year period after the firm's registration with FINRA's Central Registration Depository system.

Under the current rule, once a firm files a retail communication based on a template, no further filing is required when the template is updated for new statistical or other non-narrative information. The proposed amendments would broaden the filing exclusion to cover updated non-predictive narrative descriptions of market events during the period covered by the communication, and factual descriptions of portfolio changes.

The other proposed amendments relate to registered investment companies, including:

- Excluding from the filing requirements investment company shareholder reports that have been filed with the Securities and Exchange Commission;
- Eliminating the requirement to file ranking and comparison backup material for retail communications that contain a fund's performance ranking or performance comparison, and instead requiring firms to maintain backup materials as part of their records;
- Excluding from the filing requirements generic investment company retail communications that do not promote a particular fund or fund family, instead requiring the filing of retail communications that promote or recommend a specific registered investment company or family of registered investment companies; and
- Eliminating the filing requirements for investment company analysis tool report templates and retail communications concerning those tools.

The comment period expires on July 2, 2015.

Additional Guidance on Communications: New FINRA FAQs

Institutional Communications. Some structured product dealers provide institutional-only communications to other dealers, but do not necessarily have full control over any subsequent distribution of those communications by the third-party dealer. Accordingly, they may be reluctant to use these materials without assurances from the other dealer that the materials will not be distributed to retail investors. The new FAQ clarifies that institutional communications that are adequately labeled as such may be assumed to be distributed only to institutional investors, absent knowledge to the contrary by the member firm. A member firm may reasonably rely on a legend to the effect that the communication is for institutional use only. The advice in this new FAQ expands on the "reason to believe" standard expressed in Rule 2210(a)(4)[4] and reiterates the advice previously given by FINRA relating to procedures designed to prevent institutional communications from being forwarded to retail investors.[5] The FAQ provides a bit more comfort to broker-dealers who distribute materials of this kind to third parties.

Social Media. FINRA's new FAQ also restated earlier guidance stating that posts on the interactive electronic forum portions of social media sites are excepted from the principal pre-use and filing requirements of Rule 2210. We note that the exception is predicated on a firm supervising such communications as they would correspondence under Rule 3110(b).[6]

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FINRA is expected to release additional proposals arising from its review of the communications rules. Some of these are likely to relate to structured product offerings, including the long-awaited clarification of the use of "backtested" data in connection with proprietary indices and other newer market measures.

[4] "No member may treat a communication as having been distributed to an institutional investor if the member has reason to believe that the communication or any excerpt thereof will be forwarded or made available to any retail investor."
[5] See FINRA Notice 12-29 at 6. FINRA Notice 12-29 (June 14, 2012) can be found at: http://www.finra.org/sites/default/files/NoticeDocument/p127014.pdf.
[6] FINRA Rule 2210(b)(1)(D); see FINRA Notice 12-29 at 7.

FINRA's Revised Sanction Guidelines

In May 2015, FINRA issued revisions to its Sanction Guidelines.

In particular, the amended Sanction Guidelines encourage individual bars and firm expulsions as to:

- violations involving fraud, misrepresentations, or material omissions of fact; and
- violations of FINRA's suitability rules.

Currently, broker-dealers who offer structured products continue to be examined by FINRA for compliance with applicable rules. Accordingly, the new guidelines increase the importance of maintaining proper compliance practices and procedures.

Our client alert, "FINRA's Revised Sanction Guidelines: Higher, Tougher, Fairer?", may be found at the following link: http://www.mofo.com/~/media/Files/ClientAlert/2015/05/150518FINRAsRevisedSanctionGuidelines.pdf.

A Uniform Fiduciary Duty Standard and the Structured Products Market

Although most of the rulemakings required to be proposed and adopted pursuant to the Dodd-Frank Act have now been addressed by regulators, a fiduciary duty or other heightened standard for broker-dealers remains an unknown. Chair White has announced that addressing a fiduciary standard remains a high priority for the SEC. The recent release by the Department of Labor of a reproposed definition of a "fiduciary" under pension plans under the Employee Retirement Income Security Act, or ERISA, has raised significant concerns for the broker-dealer community.

The precise contours of any heightened standards that the SEC will propose for broker-dealers remain unclear. However, broker-dealers that offer structured products may want to focus on the effect that a "fiduciary" standard would have on structured products compared to other asset classes.

Given the fact that in the United States at present, structured products are issued by a relatively small number of financial institutions and are distributed at least initially by the broker-dealer affiliates of the issuers, a few potential conflicts of interest are almost unavoidable.

- As noted above, the products are frequently issued by an affiliate (typically, the parent corporation) of the broker-dealer, and the broker-dealer usually acts in a principal capacity in respect of the offers of the products.
- The broker-dealer will earn compensation from the sale in a variety of ways, including its underwriting commission, and any profits that it or its affiliates receive from providing a related hedge transaction to the issuer.
- The broker-dealer frequently will act in a variety of different capacities in connection with the transaction, including serving as calculation agent for the note, and in the case of a proprietary index, serving as calculation agent for the index, and may receive license fees for providing the index.

The manner of sale of these products is also more likely to raise questions if brokers are subject to the same fiduciary standard as that of investment advisers. These products are typically underwritten by the relevant broker-dealer, and resold to the investor in a principal transaction. Accordingly, the new rules will need to address or replace the principles and procedures set forth in temporary Rule 206(3)-3T. Without this temporary rule or a similar provision, Section 206(3) of the Advisers Act would prohibit registered investment advisers from engaging in principal transactions with their clients unless they obtain written consents for each individual principal transaction.

Once the securities are outstanding, if there is a secondary market, it is typically maintained only by the relevant broker-dealer. As a result, the relevant broker-dealer will typically be the only entity that is setting a resale price for the product, and the investor will be forced to accept this price if it seeks liquidity.

FINRA and CARDS

As readers of this publication know, FINRA has proposed its Comprehensive Automated Risk Data System ("CARDS"). The system would require broker-dealers to submit to FINRA, in an automated, standardized format, specific information about their customers' accounts and the customer accounts of each member firm for which they clear.

Critics of the proposal have focused in particular on the potential threat to investor privacy posed by the significant amount of data that would be recorded electronically. FINRA has responded that, for now, it will not move ahead with the present form of the proposal until it concludes that the relevant concerns have been addressed.

Our client alert, "FINRA is Apparently Holding its CARDS," may be found at the following link: http://www.bdiaregulator.com/2015/05/finra-is-apparently-holding-its-cards/.

The SEC, Structured Products, Disclosure, and Retail Investors

In May 2015, Amy Starr, the Chief of the SEC's Office of Capital Markets Trends, spoke before an industry conference.[7] She addressed a variety of issues that are of interest to market participants, which we summarize in this article.[8]

Estimated Initial Value

Ms. Starr reviewed the 2012-2013 process that led to the SEC's guidance on the disclosure of estimated values for structured notes. She expressed satisfaction that issuers have been providing the required disclosures, and that other non-U.S. regulators have taken a similar position as to these disclosures.

Disclosures Regarding Underlying Assets

Ms. Starr encouraged the market to focus on disclosure requirements for linked assets, such as securities and indices. She reminded the audience about the disclosure obligations set forth in the so-called "Morgan Stanley" or "reading room" letter.[9]

Issuer Concentration. Ms. Starr discussed the issue of concentration of a particular issuer or security in an index or basket. The concentration impacts the degree of exposure that the particular structured product has to the relevant structure issuer or component security. Ms. Starr indicated that the SEC would request relevant disclosures along the lines of the Morgan Stanley letter where there are concentrated exposures of **20%** or more to particular issuers or their securities.[10] This position would remove a degree of uncertainty, as well as inconsistent market practices as to a variety of indices, particularly ones that track non-U.S. markets, and that have a significant concentration of a particular issuer that is not a U.S. public company.

Post-Issuance Information Relating to Underlying Assets. Ms. Starr noted that structured note offering documents included historical and current information relating to the relevant reference assets. However, she asked whether issuers or others were making this type of information available to investors post-issuance in order to enable investors to evaluate their investment, and whether investors know where they can obtain this information.

Exchange Traded Notes

Ms. Starr referenced the SEC's 2014 "sweep letter" relating to ETNs, in particular the focus on providing "intraday indicative values as to a third-party index," and ensuring that the relevant disclosures were adjusted to help investors understand what relevance these figures have to the value of their ETNs. She also noted that the SEC Staff has

[7] The full speech may be found at the following link: http://www.sec.gov/news/speech/speech-amy-starr-structured-products-.html.
[8] Of course, Ms. Starr reminded the audience that the views expressed were her own, and not necessarily those of the SEC.
[9] A copy of the letter may be found at the following link: http://media.mofo.com/files/Uploads/Images/Morgan-Stanley-6-24-1996.pdf.
[10] Here, Ms. Starr referenced the position articulated in the SEC's "Asset Backed Securities Release," Release No. 33-8518 (Jan. 7, 2005) 70 FR. 1506, 1547-48.

observed improvements in the disclosures for those ETNs that use a VWAP calculation of the index components for their notes, as opposed to an end of day index value.

Proprietary Indices

Ms. Starr noted the growth in the use of these indices, and raised a number of questions relating to proprietary indices as well that should be considered by market participants:

- Is the disclosure of the key features of the index, including embedded fees and costs, understandable to retail investors?
- Do the brokers and advisors selling these products understand the nature of the products, and their risks?
- Are broker-dealer policies relating to sales and supervision being properly implemented to ensure that these products are being properly sold?

Know Your Distributor

Ms. Starr raised a variety of concerns about the use of third-party distributors:[11]

- If third-party distributors are being used, do the product manufacturers know how the products are being sold?
- Do these distributors provide any incentives to their sales force that raise concerns about the potential for unsuitable recommendations?
- Are distributors considering the financial sophistication of the customer when selling complex structured products?
- Are distributors considering any limitations on the type of investors to whom these notes may be sold, or employing investment concentration limitations?

Product Development and Suitability

While the SEC principally regulates prospectus disclosures, Ms. Starr encouraged product manufacturers to consider a variety of related questions in connection with new product development:

- Does the new product "make sense" for retail investors?
- Can the new product be readily explained to investors who are not sophisticated?
- Should the new product be made eligible for sale for retail investors in the first place?
- In designing new products, are product manufacturers considering the relevant economic studies as to the value of these instruments, some of which may suggest that they are being mis-priced?
- Are other products potentially available that involve lower costs, or that are more transparent?

Non-Registered Offerings

Ms. Starr also focused on structured products that are sold in a "wrapper" other than registered notes, such as "bank notes" and certificates of deposit. She indicated her concern that these products may be similar to those for registered offerings, but may be providing less disclosure, both about the product, and the relevant issuer and its finances.

Conclusion

Ms. Starr reminded the audience that both the Office of Capital Markets Trends and the SEC Enforcement Division are paying careful attention to these products, complaints about them, and possible securities law violations. We expect this regulatory attention to continue.

[11] Some of these issues were raised in FINRA's Conflicts of Interest Report, issued in October 2013. (http://www.finra.org/sites/default/files/Industry/p359971.pdf).

SEC Division of Market Regulation Request for Comment Discusses Exchange-Traded Products

On June 12, 2015, the SEC issued a Request for Comment on Exchange-Traded Products (ETPs).[12] The request addresses legal standards and other regulatory positions relating to the trading of ETPs, securities exchange listing standards, market pricing and arbitrage mechanisms. In the press release announcing the request, SEC Chair Mary Jo White noted the growing complexity of ETPs and that public input is being requested "to inform our evaluation of how they should be listed, traded, and marketed to investors, especially retail investors."[13] The request also invites comments on "how market professionals sell ETPs, especially to retail investors, and on investors' understanding of the nature and use of ETPs." The bulk of the request relates to exchange-traded funds, but there are some requests relating specifically to exchange-traded notes (ETNs), the key aspects of which are summarized and discussed in this article.

Arbitrage and Market Pricing

The request discusses the role of arbitrage by various market participants in generally keeping the market price of the ETP from diverging significantly from the value of the underlying asset. In an orderly market, ETN arbitrageurs accomplish this through redemptions, when the ETN is trading at a discount to its indicative value, or by selling the ETN in the secondary market, when the ETN is trading at a premium to its intraday indicative value.

The effect of arbitrageurs' actions in minimizing any premium or discount between the trading price of an ETN and the value of the underlying asset (as reflected in its indicative value) is extremely important in understanding the regulatory relief that makes ETNs permissible. Issuers of ETNs are regularly "creating," or issuing, new ETNs, and reselling ETNs that have been previously redeemed or repurchased. Due to the ongoing creations, the "restricted period" of the ETNs, for purposes of Regulation M, does not end until the ETN is called or matures. The affiliated broker-dealers of ETN issuers engage in market-making activities in the ETNs, constantly purchasing and selling ETNs in the market. Absent regulatory relief, redemptions by the issuer and market-making bids and purchases by the affiliated broker-dealer during an ongoing distribution (the restricted period) would constitute impermissible market manipulation under Regulation M.

In order to address these Regulation M issues, in 2006, Barclays Bank plc received the iPath no-action letter from the Division of Market Regulation, under which the SEC staff granted relief from Rules 102 and 101 of Regulation M for the redemption of ETNs by the issuer and the market-making activities of its affiliated broker-dealer.[14] In the iPath Letter, the staff agreed that the availability of real-time pricing information for both the ETNs (due to their NYSE listing) and the underlying reference asset (index levels being publicly available in real time), plus the ability of arbitrageurs to redeem ETNs and purchase new ETNs, would prevent any significant differences between the trading price of the ETNs and the value of the underlying reference asset. Counsel for Barclays noted, however, that the arbitrage mechanism might not be effective for short periods of time due to, among other factors, supply and demand for the ETNs.[15]

Request number eight asks about arbitrage as it relates to ETNs. Among other items, that request asks "[h]ow is arbitrage affected by ETN issuers' ability to suspend and restart issuances of notes at their discretion? How are arbitrage opportunities affected when an issuer suspends the issuance of its ETNs?"

The first part of this request begs the question as to why, in light of recent ETN litigation, an issuer would suspend and then restart issuances of its ETNs (unless the issuer enjoys dealing with plaintiffs' lawyers).[16] One ETN issuer, due to internal position limits, temporarily suspended issuances of its ETN. Within a few days, the issuer restarted issuances. Due to supply and demand, the ETN began trading at a significant premium to its indicative value. Once issuances were restarted, trading prices then quickly converged with the indicative value. Some investors sued, claiming that they were not adequately informed of this possible situation. The issuer prevailed in court, due, in part, to sufficient risk factor disclosure about this very possibility.

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[12] The request is available at: http://www.sec.gov/rules/other/2015/34-75165.pdf.
[13] The press release is available at: http://www.sec.gov/news/pressrelease/2015-118.html.
[14] Barclays Bank PLC, Staff No-Action Letter (July 27, 2006) (the "iPath Letter").
[15] *Id*. at n.10.
[16] We discussed this litigation in Volume 5, Issue 6 of Structured Thoughts, available at: http://www.mofo.com/~/media/Files/Newsletter/2014/08/140811StructuredThoughts.pdf, and in Volume 6, Issue 1 of Structured Thoughts, available at: http://www.mofo.com/~/media/Files/Newsletter/2015/01/150126StructuredThoughts.pdf.

In response to the first question quoted above, the answer may be that a professional arbitrageur would likely be able to take advantage of this temporary premium due to a suspension of issuances, but a retail investor might suffer great loss by purchasing at a premium and then being caught holding the ETN when the premium disappears. If an inexperienced ETN investor were to redeem its ETN at a time when a temporary premium exists, the redemption price would not reflect the premium.

Some issuers have temporarily suspended issuances of their ETNs and have not restarted them. Those issuers have issued several press releases warning that due to an imbalance of supply and demand in the secondary market for their respective ETN, the ETN either was trading, or might begin trading, at a significant premium to its indicative value. Typically, these issuers, in their press releases, have stated that they expect the premium to continue and to fluctuate. Consequently, the ETN would be unsuitable for most investors because the ETN will not track the price of the underlying reference asset in a consistent manner. The reason for this type of communication is most likely to warn away retail investors from the ETN.[17] Arbitrageurs, however, are better equipped than retail investors to trade in this situation.

Whether during a temporary suspension of an ETN issuance followed by a resumption of issuances, or during a long-term suspension of an ETN issuance, the normal effect of arbitrageur's activities in keeping the trading price and the indicative value close will be disrupted. Consequently, although arbitrageurs may be able to work the market to their gain, they will not be able to achieve price parity between trading prices and indicative values when an issuer is not creating new ETNs.

Request number 11 asks if investors or other market participants use intraday or closing indicative values for ETNs, and, if so, for what purpose. How does the intraday or closing indicative value differ from the market value of an ETN or its redemption amount?

The intraday and closing indicative values, which are issuer-calculated values of the ETN based on intraday and closing underlying reference asset values, respectively, and take into account the applicable investor fees at the time of calculation, are used by market participants as a close approximation of the redemption value of an ETN. Indicative values are one of the tools used by arbitrageurs and other investors in determining whether to hold, sell, purchase or redeem an ETN when there is a price differential between the trading price and the indicative value.

In February 2014, the Division of Corporation Finance, Office of Capital Market Trends, sent a "sweep" letter to various ETN issuers in which issuers were asked to improve their disclosure relating to, among other things, intraday indicative value, how intraday indicative value is calculated, why it is valuable to investors, and the relationship between intraday indicative value, the trading price and the redemption price. The sweep letter asked issuers to include a risk factor about the potential for the ETN trading at a premium or discount in relation to the intraday indicative value or redemption price of the ETN.[18]

Partly in response to the ETN sweep letter, ETN prospectuses clearly disclose the differences between the trading price, intraday indicative value and redemption price, and warn investors that they may not be able to take advantage of, and may actually lose money with respect to, price disparities between the trading price and indicative value. Investors are also warned that they are subject to market risk when they redeem their ETNs, because the redemption price will be set at the close of the trading day after their redemption request is accepted. Accordingly, if the ETN is trading at a discount (the trading price is less than the indicative value) and an ETN holder exercises its redemption right, if the trading price increases during the day after the redemption request is accepted, the ETN holder will have lost the opportunity to take advantage of the discount.

Exchange Act Exemptions and No-Action Positions

Request 19 focuses on the Regulation M relief provided by the iPath Letter, and if there are situations in which that relief should be limited.

The request asks about how the Regulation M relief should apply when the issuer has suspended ETN issuances, causing price disparity, as discussed above. The answer is simple – if issuances are suspended, there is no Regulation

[17] The New York Stock Exchange maintains a list of ETPs that have suspended issuances of new shares at: https://www.nyse.com/products/etp-closed-creation. That site also warns of the potential for the ETP's market price to deviate from the net asset value, and increased volatility.
[18] We discussed the ETN sweep letter in Volume 5, Issue 3 of Structured Thoughts, available at: http://www.mofo.com/~/media/140409StructuredThoughts.pdf.

M restricted period and issuer redemptions and affiliated broker-dealer market making activities would not be in violation of Regulation M.

The request also asks whether the Regulation M relief should "be limited to ETNs where there is a clear, independent index, where there is no limitation on issuances or redemptions, or where an ETN's secondary market price does not vary substantially from the relevant reference index? What effect would such a change have?"

The standards for an index or any other permissible reference asset underlying an ETN are set out in the listing rules of the relevant national securities exchange.[19] Those rules set forth the minimum requirements for the underlying reference asset. In the case of an equity index, for example, the NYSE Arca Equity listing rules cover the minimum number of index components, minimum market value for each index component, minimum monthly trading volume, weighting limitations and component issuer Securities Exchange Act reporting requirements, among others. The listing rules also require that firewalls be maintained to generally prevent interference by broker-dealer personnel with personnel maintaining and calculating the index and that procedures be in place to prevent the misuse of material, non-public information. The rules do not prohibit linking an ETN to an index sponsored or calculated by an affiliate of the ETN issuer.

Given that ETNs must satisfy the NYSE Arca Equity Rules, and that the liquidity provided by an exchange listing was one of the key elements underlying the Regulation M relief provided by the iPath Letter, one wonders what the Division of Market Regulation means by a "clear, independent index" and what this proposed additional requirement could mean.

ETN issuers that are subject to an internal position limit include in the ETN prospectus disclosure about that limit, and related risk factor disclosure of how the trading price of the ETN may be affected if issuances are suspended due to reaching the internal limit. This is viewed as good disclosure, a clear warning to investors that, in the future, premiums or discounts to the indicative value may exist. Excluding these ETNs from the Regulation M relief would not only keep many ETNs out of the market, but also would cause existing ETN issuers that have reached their disclosed position limits to be forced to issue ETNs in order to continue to maintain parity between the trading price and the indicative value.

The suggestion that Regulation M relief should not be available to an ETN for which the secondary market price varies substantially from the relevant reference index is potentially unworkable. Not all ETNs trade at a premium or discount as a result of a temporary issuance suspension. ETNs with small market capitalizations may be partially illiquid, causing their trading price to deviate from their intraday indicative value. For example, in mid-March of this year, it was reported that one ETN traded at a 13% discount to its net asset value on March 16, 2015. That ETN had $6.49 million in assets at that time, and had only traded seven days in 2015 up to that date.[20] If the Regulation M relief was denied to that ETN and others with sparse trading, the issuer would be punished for issuing an ETN that was not trading well.

Conclusion

The request casts a very wide net and, with respect to ETNs, seems to cover some of the same ground as the ETN sweep letter. Industry participants should respond to the requests and highlight how some of the suggested changes could be potentially damaging to the ETN market.

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

[19] See NYSE Arca Equities Rule 5.2(j)(6) (Equity Index Linked Securities).
[20] See generally Bloomberg Brief Structured Notes (March 19, 2015) at 1.

Morrison & Foerster was named Best Law Firm for Derivatives – US, 2015 by *GlobalCapital* at its US Derivatives Awards.

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, 2014 and 2015 by *Structured Retail Products.com*.

Morrison & Foerster was named Legal Leader, 2013 by *mtn-i* at its Americas Awards. Several of our 2015 transactions were also granted awards of their own as a result of their innovation.

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