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# STRUCTURED THOUGHTS

NEWS FOR THE FINANCIAL SERVICES COMMUNITY

## IN THIS ISSUE



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# FINRA 2018 EXAM PRIORITIES: SUITABILITY AND COMPLEX PRODUCTS REMAIN FRONT AND CENTER

In January 2018, FINRA released its annual examination priorities letter.[1] The letter addresses a variety of areas that are important to U.S. broker-dealers. However, as it has in the past, FINRA remains concerned about whether complex products are being properly sold.

According to the letter:

> "As the number and complexity of products available to investors continue to increase, FINRA will continue to assess the adequacy of firms' controls to meet their suitability obligations. This includes reviewing how firms identify products that are subject to new product vetting, the vetting process itself, and the supervisory systems and controls firms put in place to ensure personnel are appropriately educated and trained on the sale and supervision of the product and that recommendations are suitable. [footnote omitted] As part of the vetting process, firms should identify the risks associated with a product and include those risks in their product training so that registered representatives can appropriately evaluate them prior to recommending the product to a customer. FINRA will pay particular attention to suitability determinations in those situations where registered representatives recommend complex products to unsophisticated, vulnerable investors.
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> . . .Moreover, FINRA will review for recommendations that result in undue concentration in securities positions, including recommendations resulting in concentrated positions in interest-rate-sensitive instruments or recommendations that result in short-term trading of products typically intended to be held on a long-term basis."

We anticipate that broker-dealers will continue to exercise due care when it comes to training and supervision in connection with sales of structured products.

For additional discussion of FINRA's examination priorities letter, as well as that of the SEC's Office of Compliance Inspections and Examinations, please see our client alert, which may be found at the following link: https://media2.mofo.com/documents/180208-ocie-examination-priorities.pdf.

1 The letter may be found at the following link: http://www.finra.org/industry/2018-regulatory-and-examination-priorities-letter.

# SALES OF STRUCTURED NOTES TO ADVISED ACCOUNTS

Historically, most sales of structured notes have been made through brokerage accounts, in which the relevant financial advisor receives a commission for making the sale. However, a significant portion of structured notes are sold through advisory accounts, in which the relevant financial advisor is paid an annual fee based upon the size of the account under management and does not receive compensation for a specific investment transaction.

Due to this difference, sales to advised accounts can often be made on more favorable terms than sales to brokerage accounts – the relevant fee need not be baked into the terms of the notes. Accordingly, sales to advisory accounts, when compared to offers to brokerage accounts, may have a superior return profile.

Distributors of structured products typically implement these different terms in two different ways:

- Offering two slightly different securities to the brokerage channel and the advisory channel (so-called "separate CUSIPS"); or

- Offering only one security to both channels, but offering a discounted purchase price to advisory accounts, reflecting the brokerage commission that is not paid.

*Separate CUSIPs.* In this approach, a product manufacturer will sell two different notes, each to the relevant accounts. As noted above, the notes sold to the advisory channel will have more favorable terms. Accordingly, from a "reasonable basis suitability" perspective, as required under the FINRA rules, the product manufacturer must satisfy itself that each series of notes, when taking into account the relevant costs and potential benefits, are each a reasonable product for the relevant types of purchasers. (Of course, the investor-specific suitability standard of FINRA's rules would need to be assessed on a case-by-case basis.)

*Discounted Offering Price.* In this approach, only one series of notes will be offered, and investors in each of the brokerage channel and the advisory channel will be offerees for those notes. However, because all or a portion of the brokerage commission will not apply to the advised accounts, the advised accounts will pay a lower purchase price. This lower price increases the likelihood that they will earn a profit on their investment or avoid a loss of part of their initial investment. For example, if an investor pays 98 cents for each dollar investment, but the return on the notes is 99 cents for each dollar in principal amount, this investor will make a profit, even though investors who purchased at par will lose a portion of their investment.

Here, FINRA's rule relating to fixed price and variable price offerings (FINRA Rule 5141) comes into play. A FINRA member may not offer an undisclosed discounted price to a non-FINRA member. Accordingly, these offerings are typically made with prominent disclosures on the cover page, and/or the "plan of distribution" section, setting forth the nature of the discounted price paid to advisory accounts.

*Effect on Estimated Initial Value.* Because the offering terms of notes for advised accounts are often more favorable, we have seen situations in which the issuer's estimated value of the relevant notes equals or exceeds the public offering price. In such a case, many of the disclosures mandated by the SEC's 2012 SEC "sweep letter"[2] and related follow-up correspondence with issuers may not be applicable and can in principle be deleted. Each such situation needs to be assessed based on the relevant facts.

2 See the following links: http://media.mofo.com/files/uploads/Images/130221-SEC-Follow-up-Letter-to-Issuers.pdf and https://www.sec.gov/divisions/corpfin/guidance/structurednote0412.htm.

# HISTORICAL PERFORMANCE GRAPHS: SAYING FAREWELL TO THE FINANCIAL CRISIS?

In a prior issue of this publication,[3] we discussed the length of the period for which structured product offering documents set forth historical information about the relevant underlying asset – historical stock prices, index levels, basket performance, etc. The significant market volatility that we all experienced in February 2018 reminds us a bit of another prior period – the 2008 financial crisis – and how that period left its own mark on many offering documents.



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After all, a number of market participants sought to ensure that historical performance presentations would be sufficient in length to demonstrate the volatility (and market declines) experienced in 2008. This year, we recall (somehow "celebrate" doesn't seem like quite the right word) the tenth anniversary of that period.

For those issuers that typically show ten years of historical performance, this may be the last year of using offering documents that show 2008 information.

Would investors lose out by not seeing that period in offering documents? Perhaps not. First, the SEC's guidance suggests that a much shorter period of historical performance can be set forth. (Two years, plus the current year.[4]) In addition, the performance of the equity markets during that period is by no means a secret and is easily available to all investors at no charge through a variety of widely available financial websites.

Of course, removing history from a document doesn't remove history from reality.[5] Investors and financial advisors need to remain mindful of the risks that market downturns pose to the market value of an instrument and the payments on the instrument.

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3 https://media2.mofo.com/documents/160210structuredthoughts.pdf.

4 See the "reading room" no-action letter, available at the following link: http://media.mofo.com/files/Uploads/Images/Morgan-Stanley-6-24-1996.pdf.

5 Pretty deep words, yes?

# MASSACHUSETTS CHARGES BROKER-DEALER IN CONNECTION WITH VIOLATIONS OF DOL FIDUCIARY RULE

In February 2018, the Enforcement Section of the Massachusetts Securities Division of the Office of the Secretary of the Commonwealth (the "Enforcement Section") charged a registered broker-dealer that operated in Massachusetts with violating its own internal policies designed to ensure compliance with the U.S. Department of Labor's Fiduciary Rule.

The broker-dealer had adopted provisions in its compliance manuals that were designed to address the requirements of the DOL rule. The Enforcement Section alleged, however, that, while those compliance manuals stated that the firm would not use contests, special awards, or incentives to cause associates to make recommendations not in the best interest of retirement account clients or prospective clients, in fact the broker-dealer ran sales contests that included aggressive sales practices without appropriate disclosures of relevant conflicts of interest.

This action demonstrates the regulatory actions that can be faced by broker-dealers under both federal and state law if their practices are not appropriately tailored to the requirements of the DOL rule.

For a more detailed discussion of these developments, please see our article, which may be found at the following link: https://www.jdsupra.com/legalnews/first-state-charges-broker-dealer-in-89394/.

# SEC COMMISSIONER STEIN HIGHLIGHTS CONCERNS REGARDING RETAIL INVESTORS AND COMPLEX STRUCTURED PRODUCTS

At a speech at last month's "SEC Speaks" conference, SEC Commissioner Kara M. Stein raised familiar concerns regarding purchases by retail investors of complex structured products. Analogizing such financial products to the genetic engineering of dinosaurs in the movie *Jurassic Park*, she defined the essential question as not what is technologically *possible* but what is *advisable*.

Among her questions, she stated, were the extent to which retail investors truly understand complex products, and the degree to which they receive information, by means of discussions with brokers or otherwise, to permit them to evaluate complex products and their potential outcomes and risks.

Complex products and strategies that Stein noted could contain pitfalls for retail investors include



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exchange-traded VIX-based products, structured notes linked to bespoke indices, and certain leveraged and complex passive investment strategies.

Although the SEC has brought numerous enforcement actions, it continues to see abuses relating to purchases and sales of complex products, Stein said.

She stated that addressing this problem would require the SEC, FINRA and the exchanges to be able to understand the full impact of complex products on investors and U.S. markets, including by means of the consolidated audit trail. Further, Stein said, exchanges that list complex products must be able effectively to surveil for problems, and industry professionals and gatekeepers should act as part of the solution, not part of the problem.

Stein's speech is available at this link: https://www.sec.gov/news/speech/stein-sec-speaks-increasing-product-complexity.