

STRUCTURED THOUGHTS

NEWS FOR THE FINANCIAL SERVICES COMMUNITY

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FINRA RESTATES AND UPDATES GUIDANCE AS TO PRE-INCEPTION INDEX PERFORMANCE DATA

In a January 2019 interpretative letter, the Financial Industry Authority (FINRA) provided guidance to a registered broker-dealer as to the use of pre-inception index performance (PIP) data relating to a proprietary index. The broker-dealer sought to use the information in communications about open-end investment companies, which would be distributed solely to “institutional investors.” The full text of the letter may be found [here](#).

The letter restates and updates FINRA’s prior guidance as to the use of back-tested index information, including its historic position that the use of this type of information would be inappropriate in communications provided to retail investors. FINRA’s previous advice was set forth in a 2013 letter to ALPS Distributors.¹ The guidance in the letter is useful to some extent to issuers of structured notes and structured CDs that are linked to new or proprietary indices.

¹ FINRA’s 2013 letter to ALPS Distributors may be found [here](#).

In the new letter, FINRA approved of the use of the PIP data, subject to a number of conditions, including:

- Marketing materials that include PIP data must be labelled “For use with institutions only, not for use with retail investors.” Financial intermediary recipients must be instructed not to circulate these materials to retail investors. If such a recipient distributes the information to retail investors, the broker-dealer must cease distributing the materials to that recipient.
- The PIP data can only be used with respect to an index that was created according to fixed rules that cannot be changed except under extraordinary conditions.
- Marketing materials containing PIP data must include an offer to provide an overview of the methodology of the index upon request, and electronic marketing material must include a hyperlink to that information.
- The presentation of the PIP data must reflect the deduction of fees and charges that are currently applicable to the relevant investment funds.
- The PIP data must reflect a period of time that includes multiple securities market environments and, at a minimum, 10 years of pre-inception data.
- The PIP data must be current as of the most recently ended calendar quarter.
- The PIP data must be clearly labelled and shown separately from the relevant fund’s performance; it must be presented along with disclosure of the applicable dates for the PIP data and the dates for actual performance since inception.
- Because the fund in question was in existence for more than one year, the PIP data must be accompanied by the prominent presentation of the actual performance of the fund since inception, which reflects the deduction of fees and charges of the fund.
- The PIP data should not be inconsistent with information in the fund prospectus. (However, the PIP data may be used with institutional investors, regardless of whether the fund prospectus includes the data.)

- The PIP data should be accompanied by a few disclosures:
 - that the fund in question is a relatively new product, and any performance prior to the date of inception is hypothetical;
 - the identity of the entity that performs the calculation and distribution of the PIP data, and the fact that the relevant investment advisor pays this entity to perform those functions;
 - the fact that the PIP data are based on criteria that has been applied retroactively with the benefit of hindsight, and that these criteria cannot account for all of the financial risk that may affect the actual performance of the fund;
 - that the actual performance of the fund may vary significantly from the PIP data; and
 - the reasons (if any) why the PIP data would have differed from actual performance during the period shown (e.g., transaction costs, liquidity, or other market factors).

As noted above, FINRA also restated in the letter its historic position that the use of hypothetical back-tested performance information in communications with retail investors does not comply with FINRA’s content rules.

The letter does not materially change FINRA’s guidance for the use of this type of information; however, it remains useful guidance as to the issues to consider when presenting the information in an offering document or marketing materials.

FINRA EXAM PRIORITIES AND STRUCTURED PRODUCTS

In January 2019, FINRA issued its annual “Risk Monitoring and Examination Priorities Letter.” The full text of the letter may be found [here](#).

The letter addresses a variety of issues that must be addressed by all broker-dealers, whether or not they offer structured products. This particular asset class is not discussed at length in the letter, possibly due in part to FINRA’s note in its introduction that: “we

do not [in this letter] repeat topics that have been mainstays of FINRA’s attention over the years.”

However, the letter makes it clear that sales of complex products, including structured products, must be reviewed as to whether they comply with FINRA’s suitability rules. In particular, the letter notes that:

“As the exchange-traded product (ETP) market continues to grow with novel and increasingly complex products, FINRA will evaluate whether firms are meeting their suitability obligations and risk disclosure obligations when recommending such products. These include leveraged and inverse exchange-traded funds (ETFs), floating-rate loan ETFs (also known as bank-loan or leveraged loan funds) and mutual funds that invest in loans extended to highly indebted companies of lower credit quality.”

KICKING THE CAN DOWN THE ROAD: ESAS PUBLISH FINAL REPORT ON AMENDMENTS TO PRIIPS KID

On February 8, 2019, the European Supervisory Authorities² (ESAs) published a Final Report³ relating to a joint Consultation Paper⁴ (the “Consultation Paper”) they published in November 2018, consulting on possible amendments to the PRIIPs Delegated Regulation referred to below.

BACKGROUND

The EU Packaged Retail Products and Insurance-based Investment Products Regulation⁵ (the “Regulation”) became effective on January 1, 2018. Under the terms of the Regulation, whenever an in-scope product is offered to an EU retail investor (defined as a “retail client” under MiFID II), an additional short form Key Information Document

² The ESAs comprise the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA)

³ [European Supervisory Authorities Final Report February 8, 2019](#)

⁴ [European Supervisory Authorities Joint Consultation Paper concerning amendments to the PRIIPs KID, November 2018](#)

⁵ [EU Packaged Retail Products and Insurance-based Investment Products Regulation](#)

(KID) must be provided to that investor before it makes its investment decision.

The Regulation is prescriptive as to what information the KID should contain and the order in which information should be presented. An EU Delegated Regulation⁶ (the “Delegated Regulation”) sets out detailed regulatory technical standards relating to the preparation of the KID and the information to be included in it.

In the lead-up to the Regulation and the Delegated Regulation coming into effect, significant market concern was raised that certain of the required disclosures could be misleading in some circumstances, particularly in respect of performance scenarios and transaction costs. These concerns continued to be raised after January 1, 2018. In the UK, in January 2018, the Financial Conduct Authority (FCA) took the unusual step of publishing a statement on communications in relation to PRIIPs⁷, reminding market participants of the FCA rules requiring firms to ensure that their communications with clients are fair, clear and not misleading. The FCA stated that, where firms are concerned, the “performance scenario” information may appear too optimistic with the potential to mislead customers, it was recommended that additional explanations should be included to put the calculation in context (even though such an approach is not contemplated under the Regulation).

2018 CONSULTATION PAPER

As mentioned above, following market concerns about aspects of the Delegated Regulation, the ESAs published the Consultation Paper in November 2018 which sought feedback on a number of areas of possible amendment to the Delegated Regulation.

In terms of timing, the ESAs were concerned, in particular, that, with effect from December 31, 2019, management and investment companies advising on or selling UCITS funds would need to comply with the KID requirements under the Regulation – until that date when they are able to rely upon an exemption permitting them to continue to produce an information document in accordance with the existing UCITS Directive. The ESAs are determined that any amendments to the Delegated Regulation must be in place by the time such

⁶ [EU Delegated Regulation](#)

⁷ [The Financial Conduct Authority \(FCA\) January 2018 statement on communications in relation to PRIIPs](#)

exemption comes. They therefore proposed a relatively short consultation period and envisaged proposing amendments to the Delegated Regulation in January 2019.

However, since the publication of the Consultation Paper, the European Parliament Committee on Economic and Monetary Affairs (**ECON**) has proposed extending the end of the UCITS exemption referred to above for two years until December 31, 2021. It seems likely that the relevant ESAs will ratify and adopt the necessary legislation giving effect to such extension in the first quarter of 2019.

In regard to this anticipated extension and the feedback received in relation to the Consultation Paper, the ESAs state in the Final Report that they have concluded it is not appropriate to propose substantive amendments to the Delegated Regulation at this time. They will, however, conduct a full review of the Delegated Regulation during 2019.

To address some of the more immediate concerns in relation to performance scenarios, the Final Report contains the text of a Joint Supervisory Statement from the ESAs (the “Statement”). In the Statement, the ESAs admit that the performance scenario requirements could, in some cases, provide an overly positive outlook for potential future returns. The ESAs state that, in view of the potential risk that the performance scenarios may provide retail investors with inappropriate expectations about the possible returns they may receive, it is recommended that a statement be included in the KID warning of the limitations to the information in the performance scenarios. For a consistency in approach, it is recommended that an additional warning be added in the “Performance Scenarios” section stating in bolded text that:

Market developments in the future cannot be accurately predicted. The scenarios shown are only an indication of some of the possible outcomes based on recent returns. Actual returns could be lower.

The ESAs state that other relevant information could also include additional explanations putting the performance scenario figures in the KID in context. They stress that any steps taken should be proportionate and should provide information that is complementary to the existing information within

the KID, and that any additions to the KID should be limited to what is considered essential to ensure that the presentation of performance scenarios is fair, accurate, clear and not misleading.

The ESAs’ approach is therefore similar to that taken by the UK FCA in 2018 as outlined above.

FUTURE WORK BY THE ESAS

In relation to the proposed review of the Delegated Regulation during 2019, the ESAs state their intention to work with the EU Commission to test both the existing KID approaches and new proposals on consumers. The ESAs expect to publish a further public consultation during 2019 and indicate that the scope of this consultation is likely to be wider than the scope of the 2018 Consultation Paper. Specific areas highlighted by the ESAs as likely to be covered by the 2019 consultation include:

- Performance scenarios: both the issues highlighted in the 2018 Consultation Paper and a more detailed assessment of the methodology underpinning future performance scenarios and their presentation, including intermediate performance scenarios;
- Costs: both in relation to feedback provided to the 2018 Consultation Paper, as well as other information gathered by the ESAs following the implementation of the KID and the interaction of the requirements in relation to costs with other legislation, in particular MiFID II;
- PRIIPs offering a range of options for investment: the ESAs note that their experience since the Regulation came into effect is that there are challenges for retail investors to understand the interaction between the “generic KID” and the “specific information” for the underlying investment option, and to make comparisons between different multi-option products, particularly in relation to costs; and
- Differentiation between different types of PRIIPs: the ESAs intend to analyze if it is appropriate to introduce some additional guidance on how the rules apply to different types of products, while still adhering to the overarching aim of comparability between substitutable products.

FINAL THOUGHTS

Although the market will welcome KIDs that contain appropriate warnings and explanations as to the limitations of performance scenarios in certain circumstances, there is likely to be frustration that it has taken the ESAs this long to propose a solution to an issue highlighted prior to the Delegated Regulation coming into effect and which the UK FCA took action to address over a year ago.

In addition, although some market participants may also be frustrated that the resolution of the 2018 consultation they participated in has been further

delayed, many are likely to welcome a more comprehensive consultation that will have the benefit of the Regulation having been in force for over a year. Although market participants have expressed disappointment in the past that the ESAs have not given proper consideration to the issues that were raised, there will be some hope that meaningful improvements can be made to the Delegated Regulation during the extended and revamped consultation.

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