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Structured Thoughts

News for the financial services community.

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FINRA's Report on Conflicts of Interest: Issues for the Structured Products Market

Introduction

In October 2013, FINRA issued its long-awaited report on broker-dealer conflicts of interest.

The report, together with the remarks of FINRA's Chairman, Richard Ketchum, can be found at the following link: http://www.finra.org/Newsroom/NewsReleases/2013/P359973?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+FINRANews+%28FINRA+News%29

The report was issued after a process that FINRA initiated in July 2012. At that time, FINRA sent a targeted examination letter to several large (unnamed) brokerage firms to review their conflicts management practices, and to better understand how the industry identifies and manages conflicts.[1] FINRA based its report on information obtained from the responses to the examination letter, in-person meetings with FINRA, and a follow-up compensation questionnaire.

The report addresses many aspects of a broker-dealer's business, and many different product areas. The report provides very useful insight into FINRA's current thinking on conflicts of interest, as well as a variety of other related issues. FINRA also used the report to restate some of its prior guidance to broker-dealers on conflicts and certain other subjects.

[1] Our client alert relating to that targeted examination letter may be found at the following link: http://www.mofo.com/files/Uploads/Images/120814-FINRA-Conflicts-of-Interest.pdf

In this article, after we summarize some of the key general points of the report, we will highlight more specifically how the report relates to market participants in the structured products area.

General Highlights of the Report

In releasing the report, FINRA seeks to help firms of all sizes strengthen their frameworks for addressing conflicts of interest. FINRA acknowledges that there is no one-size-fits-all approach. However, FINRA believes that an effective conflicts management framework should address the following considerations, among others:

- Identifying and managing conflicts on an ongoing basis through an enterprise-level approach, scaled to the size and complexity of a firm's business. The framework should start with a "tone from the top" that runs through the organization's structures, policies, processes, training and culture.

- Establishing new product review processes that include perspectives that are independent from the business group proposing the products, that identify potential conflicts raised by new products, that restrict distribution of products posing conflicts that cannot be mitigated effectively, and that periodically re-assess products through post-approval reviews.

- Making independent decisions in the wealth management business about offered products, without favoring proprietary products or products that are subject to revenue-sharing agreements.

- Minimizing conflicts in compensation structures between customer and broker or firm interests where possible, and including heightened supervision when conflicts exist (for example, around bonus thresholds in a firm's compensation structure).

- Mitigating conflicts of interest through disclosures and other information that enable customers to understand the factors that may affect a product's potential returns (or to understand the fees or expenses that are associated with the product).

- Including "best-interest-of-the-customer" standards in codes of conduct that apply to brokers' recommendations to retail customers, in order to maintain and increase investor trust.

In the report, FINRA recognized that many broker-dealers have improved their management of conflicts of interest. However, FINRA believes that firms need to continue to focus on conflicts of interest, and expects firms to consider the practices presented in the report and to implement a strong conflict management framework. FINRA indicated that it will continue to review how firms manage conflicts, and that it will evaluate the effectiveness of their efforts. The report notes that FINRA may consider future rulemaking on the subject, if needed.

Identifying Conflicts of Interest

FINRA summarizes a number of conflicts of interest that it identified in its process. Perhaps not surprisingly, many are conflicts that frequently arise in the structured products industry. Most of these have been somewhat standard parts of structured product risk factor disclosures during the past several years.

Firm vs. Client Conflicts. These can arise when the firm offers or recommends products for which the firm receives greater fees or compensation than other products, or that may not be suitable for certain clients. In addition, the firm may perform multiple roles with respect to a client or transaction (e.g., advisor, underwriter, derivative counterparty). The firm may also engage in business and trading activities for its own account or client accounts that relate to the same underlying assets as the structured products.

Client vs. Client Conflicts. These can arise, for example, when the broker represents clients with countervailing positions. For example, a broker may market a structured product that is "bullish" on a particular underlying, at the same time as it has large clients that are taking a short position on that underlying.

Employee vs. Client Conflicts. These types of conflicts may arise, for example, when there are compensation arrangements or incentives for the firm or its employees that could affect whether employees recommend or offer a particular product to the client.

Disclosure

The report emphasizes the role of proper disclosures in addressing conflicts of interest. FINRA states:

> that to make disclosure effective, firms should look beyond minimum disclosure obligations under statute, regulation and case law, to identify practices that are effective in helping customers make informed decisions. In selling new products, effective disclosure may help a customer understand the factors that may affect a product's financial outcome. To this end, firms should consider whether the use of scenarios and graphics could help customers achieve this level of understanding.
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> A test to evaluate the effectiveness of their disclosure is asking, in the event of a reasonably foreseeable adverse product outcome, could an investor legitimately say, "I did not realize that could happen" on the basis of information the firm provided apart from the prospectus. If the answer is "yes," the firm should reconsider how it presents information about that product to customers. In the context of an advised sale where the firm provided its own sales materials, it is not sufficient that the relevant risk information was contained solely in the product prospectus.
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> A further effective practice is to require investors to attest to their understanding of more complex products before purchase. The process of going through this attestation may reinforce to customers the need to understand the products they purchase.

Of course, investor representation letters are very common in the case of structured products sold to institutional investors, such as in the Rule 144A context. It remains to be seen whether market participants would seek to roll them out more broadly to retail investors. And, if used, these letters may contain acknowledgements as to a variety of other significant features of certain structured products, such as potential loss of principal, capped returns, lack of interest payments, etc.) Of course, "risk factor" and other sections of relevant disclosure documents can certainly be reviewed to ensure that they make robust and understandable disclosures as to the relevant conflicts of interest and their potential impact on the relevant product.

Conflicts Clearance and Business Selection

A recurring question in the structured products market is the extent to which equity-linked instruments can be offered when a unit of the issuer or underwriter has material non-public information about the relevant stock (or index component). This could occur, for example, if the broker-dealer is advising the issuer of the underlying stock in respect of a merger or refinancing transaction.

The report does not necessarily provide new guidance from FINRA as to when and how such an offering may occur, or the types of information walls that are sufficient to address these issues.[2] However, the report highlights the importance that FINRA ascribes to maintaining procedures to ensure that these types of conflicts are appropriately identified and addressed.

Conflicts of Interest and New Product Review

The report criticized broker-dealers for demonstrating limited ability to manage conflicts of interest that can arise in the course of product innovation. To be effective, FINRA states that identifying and managing conflicts of interest associated with new business initiatives should be a key component of firms' new business planning and implementation efforts.

[2] The SEC's Office of Compliance Inspections and Examinations addressed these issues to some extent in its September 2012 report, "Staff Summary Report on Examinations of Information Barriers: Broker-Dealer Practices Under Section 15(g) of the Securities Exchange Act of 1934." (Available at: https://www.sec.gov/about/offices/ocie/informationbarriers.pdf)

The report evaluated firms' new business conflicts frameworks primarily through the lens of new product assessments. This focus reflects FINRA's concerns about increased retail sales of complex products.

FINRA observed firms engaging in a number of effective practices to identify and manage conflicts of interest that may arise through the launch of a new product:

- Firms' new product review committees include a mandate to identify and mitigate conflicts of interest associated with a new product.

- Where a conflict of interest may result in serious harm to customers, and the firm cannot effectively mitigate that conflict, the firm would decline to offer the product to customers.

- Firms differentiate product eligibility between institutional and retail clients. For retail, some firms restrict eligibility to purchase more complex products to customers whose accounts have been approved for options trading, or they establish other criteria that enable the firm to ascertain an individual's ability to understand and evaluate the risks.[3]

- Product manufacturing firms implement strong KYD policies and processes to assess potential distributors' financial soundness, marketing and sales controls, sales practice and compliance mindset, quality of distribution network and technical capabilities before allowing them to sell complex products.

- Firms conduct post-approval reviews to assess whether a product has performed as expected.

Consistent with its prior guidance, FINRA points out that an effective practice for product manufacturers is to include in their new product review process a careful analysis of the conflicts of interest that a product may raise and to establish measures to address them.

A review committee may limit access to a product to distributors with stringent suitability frameworks, restrict the customers to whom a product may be sold, or prescribe minimum knowledge requirements for registered representatives who may recommend the product.

In part to reduce the conflict of interest that would exist if a business unit were responsible for vetting its own initiative, FINRA supports having a new business initiative committee include business, support and control functions, including information technology, operations, finance, legal, compliance and risk management. The vetting process may involve various levels of seniority in the firm, depending on the perceived risk and complexity in the new product approval. In several firms, the risk management department has final sign-off authority on a product launch and the risk management group may be responsible for coordinating the review process.

Reverse Inquiry and KYD

For purposes of the report, FINRA discusses "reverse inquiry" transactions, which it describes as situations in which a distributor requests the manufacture of a structured product designed to the distributor's specifications.[4] While FINRA recommends strong "know your dealer" procedures across the board, the report indicates that it is especially important to apply good KYD practices rigorously in the context of any reverse inquiry transaction.

FINRA identified the following elements of a KYD process as reflecting effective practices:

- conducting background checks on the distributor and relevant employees (for example, through FINRA BrokerCheck, and compliance databases), including reviewing complaints or litigation;

[3] FINRA initially referenced guidelines of this type in its Notice to Members 05-59, Structured Products: NASD Provides Guidance Concerning the Sale of Structured Products, September 2005. (See http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p014997.pdf)
[4] The term may also be used more broadly by some broker-dealers, such as where a specific investor has a request for a certain type of product.

- reviewing the distributor's financial soundness;
- requiring distributors to complete a detailed questionnaire to help assess its sales practices, marketing strategy, registered representative training, investor education, compliance culture, product classification, trade review and sign-off process and distribution strength;
- interviewing the distributor to develop an understanding of the firm's compliance culture; experience, particularly with more complex products; and its capability and willingness to effectively discharge its suitability obligations;
- obtaining information about the composition and nature of the distributor's customer base
- (e.g., age, retail/institutional percentage, and experience with complex products);
- reviewing a distributor's relevant compliance manuals, written supervisory procedures and other relevant materials;
- reviewing and approving the distributor, considering the potential merits and limitations of the distributor;
- reviewing sub-distributors/sub-dealers annually; some firms require them to complete an abbreviated version of the on-boarding questionnaire annually; and
- requiring distributors/sub-distributors to sign an agreement (such as a "selected dealer agreement"), in which they commit to comply with relevant rules and regulations (including suitability and account due diligence).

As an example of how some manufacturers' KYD processes work in practice, FINRA cited the practice of several manufacturers to divide their distributors into tiers—generally three levels—based on criteria such as a distributor's product expertise and experience, the quality of its control environment, and the strength of its sales practices. Firms that are rated more highly in these areas will be permitted to distribute a broader range of products, including more complex products; distributors with lower ratings will be permitted to distribute a narrower range of simpler or more "plain vanilla" products. In a different approach reported by FINRA, one firm took a binary view of its distributors, approving them to offer all or none of its products.[5]

Structured Products and Embedded Conflicts (and Proprietary Indices Too)

The report discusses in some length the conflicts that may exist in structured products due to the roles of the parties. These conflicts often exist when the broker-dealer or its affiliate acts as calculation agent for the relevant product, or for an underlying index. In addition, particularly in the case of commodity-linked products, many calculation agents have the ability to declare a "hedging disruption event," which enables the product to be called early, with the final payment determined by the calculation agent.

The report notes that using an affiliated calculation agent is not necessarily problematic, particularly where the calculation is simple and based on readily accessible data. However, FINRA reminds market participants that the relevant disclosures should clearly articulate the conflicts of interest that may arise when using an affiliated calculation agent. In addition, the disclosure should specify if the agent will make its determinations using data not easily obtainable by the target customer. The disclosures should also include any subjective aspects of the agent's role, such as the degree of discretion it may exercise in calculating an underlying index, payouts to customers or the declaration of a hedging disruption event. In addition, to mitigate conflicts, FINRA advises issuers with affiliated calculation agents to establish governance and supervisory review processes for those agents' decisions, particularly if the agent may exercise discretion in its decision-making. These processes should be transparent and provide for the balancing of investor and firm interests.

[5] It is unclear from the report whether FINRA approved or disapproved of this approach. For example, this approach may be appropriate for a manufacturer that tends to offer only relative simple or widely understood products.

FINRA reiterated in the report some of its historic concerns about structured products linked to proprietary indices. Not all of these are directly related to conflicts of interest per se. However, FINRA recommends that these issues be considered in connection with new product approvals, registered representative training, and product disclosures:

- complexity;
- high costs, or hidden costs;
- the possibility that they involve sophisticated or complicated trading algorithms or investment strategies, which may subject investors to fee structures that can be conditional or path dependent, require detailed analysis to understand and estimate, and/or be very costly under certain conditions; and
- limited histories in which to evaluate their behavior in different market environments.

Additional Conflicts Relating to Callable ETNs

In its discussion of the embedded conflicts in complex products, FINRA also focused on exchange-traded notes. Noting that some ETNs can be viewed by investors as “buy and hold” long-term investments, these same ETNs may have a call provision under which the issuer could terminate the ETNs prematurely, at its discretion, at a significant discount to the principal amount. Such a call could unexpectedly have a negative effect on buy and hold investors. FINRA emphasized that investors should clearly be made aware of the inherent conflict of interest between the ETN issuer and the investor that is caused by such a call right.

In addition to the sales representative highlighting conflicts due to discretionary ETN call risks, issuers should revisit their risk factors to ensure that call risk disclosure clearly states that a call may occur at a time that is disadvantageous to the ETN holders.

Distribution and Proprietary Products (and Open Architecture)

The report addresses FINRA’s ongoing concerns relating to sales of products or services in order to generate revenues without proper regard to suitability standards.

In the context of firms that engage in both product manufacturing and private wealth management businesses, FINRA underscores the importance for conflicts controls of the private wealth business operating with appropriate independence from other business lines. FINRA recommends that firms maintain effective safeguards, including through the use of new product review committees in the private wealth business, against pressure to prefer proprietary products to the detriment of customer interests.

In the report, FINRA commends market participants that have adopted an “open architecture” approach that involves offering and sale of products issued by third parties. The report indicates that an effective practice for distributors—and one in which many firms engage—is to put product requirements out for competitive bid across multiple firms. (This could include, for example, choosing the issuer of a particular structured note, or selecting the party that will provide the relevant hedging transaction; in the latter case, the hedging terms are often passed along to investors in the terms of the product, such as a “cap” or a “participation rate”.) FINRA indicates that firms should consider, in selecting a product manufacturer, competitiveness and pricing, service, innovation and credit diversification.

In the context of a recommended transaction, FINRA reports that an effective practice is for a registered representative to inform a customer if a recommended product is proprietary or from a preferred provider. As part of this practice, the registered representative should provide this information in advance of executing the transaction. Providing this type of disclosure will enable a customer to make a decision about whether to proceed with a transaction notwithstanding the conflict. This disclosure may supplement the existing written disclosures that firms provide about conflicts, frequently in account opening documents, but places the disclosure in the context of a specific customer decision.

Compensation and Compensation Oversight

The report's focus on compensation of brokers is also relevant to structured products. In particular, the report reminds brokers of the risk of favoring the sales of one type of product over another (such as enhanced compensation for the sale of the broker's own structured products). FINRA commended firms that use "product neutral" compensation grids to reduce incentives for registered representatives to prefer one type of product over another.

Conclusion

FINRA has provided its report to stimulate firms' thinking, and to offer examples of how some firms address conflicts. FINRA expects that firms will use this information to support a thoughtful analysis of the conflicts they face in their business, and to implement an appropriate conflict management framework to identify, manage, or mitigate, or improve the mitigation of, those conflicts where necessary.

FINRA indicated that it will continue to focus on conflicts issues, and will evaluate the effectiveness of firms' conflicts management efforts. If firms make inadequate progress generally, FINRA will evaluate whether conflicts-focused rulemaking is necessary to enhance investor protection.

Structured Notes, Their Hedges, and Dodd-Frank

Structured notes often contain complex or idiosyncratic payout formulae, requiring the issuer to make payments based on, for example, unusual rate calculations or the occurrence or non-occurrence of particular events. The issuer typically enters into a derivative to hedge those payment obligations. In this article, we take a brief look at how Title VII of Dodd-Frank treats the hedges of structured notes for many issuers and their affiliates.

Structured Notes under Title VII

Structured notes themselves are securities and do not qualify as "swaps" or "security-based swaps" for purposes of Title VII of Dodd-Frank. Section 1a of the Commodity Exchange Act, as amended by Dodd-Frank, excludes from the definition of "swap" any note, bond or evidence of indebtedness that is a security, as defined in the Securities Act of 1933. The definition of "security-based swap" is based on the definition of "swap" and is subject to the same exclusion. The Securities Act makes clear that the term "security" includes any note or evidence of indebtedness. Accordingly, structured notes constitute securities and not swaps or security-based swaps, and Title VII of Dodd-Frank has little direct effect on them.

Hedges of Structured Notes

While structured notes are not subject to Title VII, however, swaps hedging those notes will generally be subject to Title VII. Typically the hedge consists of two distinct but very similar swaps, which together have the effect of passing to a third party unaffiliated with the issuer the obligation to make payments equal to those required to be made under the related notes. The first leg of the hedge is typically an internal transaction between the issuer of the notes and one of its affiliates, usually a swap dealer. The second leg is typically a transaction between such dealer affiliate of the issuer and an unaffiliated external hedge counterparty (which, however, may be a related party of another party to the overall transaction, such as the distributor of the notes).

Given the wide array of exposures that may underlie structured notes, one of the first questions to be asked of any derivative hedging a note is whether it constitutes a swap or a security-based swap. Swaps are subject to regulation by the CFTC, while security-based swaps are subject to regulation by the SEC. The CFTC has finalized many more of its Title VII regulations than has the SEC and, for now, at least, a swap is subject to far greater substantive regulation than is a security-based swap.

Swaps are defined to include such products as interest rate swaps, non-vanilla FX products (vanilla FX swaps and forwards having been exempted for many purposes by the Treasury Department), credit default swaps referencing a broad-based security index, total return swaps referencing a broad-based security index, total return swaps referencing more than one loan, commodity swaps, and other swaps referencing broad-based securities indices. In contrast, security-based swaps include, among other things, total return swaps referencing a single security or loan, total return swaps referencing a narrow-based index of securities, single-name credit default swaps and credit default swaps on a narrow-based index of securities. Mixed swaps, which have characteristics of both swaps and security-based swaps, are subject to joint regulation by the CFTC and SEC.

Because of the CFTC's rules regarding clearing, there is a possibility that, if the derivative required to hedge a structured note qualifies as a swap, the internal hedge may be an uncleared OTC transaction, while the external hedge may be a cleared swap. In addition, the treatment of the inter-affiliate transaction is likely to be different than that of the external swap for purposes of real-time reporting and certain of the CFTC's external business conduct rules.

The CFTC has issued one clearing determination, in which it determined that a broad range of interest rate swaps and index credit default swaps are subject to mandatory clearing. That clearing determination is now generally in effect and may apply to both the internal hedge and the external hedge employed to hedge a structured note.

However, the issuer and affiliated swap dealer that are parties to the internal hedge may determine not to clear the internal swap based on the CFTC's exemption from mandatory clearing for swaps between affiliated counterparties. Among the requirements for that exemption to apply are (i) either of the two affiliates holding majority ownership in the other, or both being under common ownership, in either case with consolidated financial statements, (ii) both parties electing not to clear the swap, (iii) the existence of swap trading documentation between the two affiliates, (iv) the inter-affiliate swap being subject to a centralized risk management program and (v) each affiliated party complying with certain additional requirements with regard to the clearing and collateralization of its swaps.

In contrast, the external hedge between the dealer affiliate of the issuer and a third party will typically be an interdealer transaction, and not subject to any exemption or exclusion from mandatory clearing, if it applies.

Because the internal hedge may be uncleared, while the external hedge may be cleared, the terms of the internal hedge may differ materially from those of the external hedge. From an economic point of view, the primary difference between the internal hedge and the external hedge is likely to be the amount of required collateral. The internal hedge, if uncleared, for now will be governed by the terms of the swap trading relationship documentation between the parties; the CFTC has not yet finalized its regulations for the collateralization of uncleared swaps. However, the relevant clearinghouse (and the dealer affiliate's clearing member) will determine the amount of margin required in relation to the external hedge, assuming it is cleared. The clearinghouse will require both initial margin and variation margin.

Other differences in the treatment of the internal hedge and the external hedge under Title VII include treatment for purposes of real-time public reporting and the CFTC's external business conduct rules. The CFTC's real-time public reporting rules do not apply to swaps that are not transacted at arms-length because those transactions do not qualify as "publicly reportable swap transactions." The inter-affiliate internal hedge would likely not be considered an arms-length transaction and (unlike the external hedge) would thus likely not be required to be reported under the CFTC's real-time transaction reporting rules. Similarly, the CFTC's external business conduct rules do not apply to transactions that are not publicly reportable; however, as many of the substantive external business conduct rules (such as those requiring a swap dealer to provide disclosures of material information, a daily mark and clearing disclosures) by their terms do not apply to inter-dealer transactions, only a subset of the external business conduct rules that would apply to the external hedge.

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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.

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