

# Structured Thoughts

*News for the financial services community.*



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## Principal Protected Note Tutorial from SEC and FINRA

The SEC’s Office of Investor Education and Advocacy teamed up with FINRA to publish an alert on principal protected notes titled “Structured Notes with Principal Protection: Note the Terms of Your Investment” on the SEC’s website at <http://www.sec.gov/investor/alerts/structurednotes.htm>.

The alert notes the growth in the structured products market and comments on the proliferation of products with different names and cautions investors to educate themselves regarding the risks inherent in principal protected products. It focuses on credit risk and on the limited secondary market and notes that principal protected products “have the potential to outperform the total interest payment that would be paid on typical fixed interest rate bonds.” However, the alert also warns against hidden fees. Overall, the alert should prove helpful to investors, but the presentation of fees may be more confusing than helpful and may serve as another indication that additional clarity on fee disclosures—from the basic notion of spreads and selling concessions, to the more complex notion of structuring fees—would benefit the market.

## FINRA Priorities

At FINRA's Annual Conference, Richard Ketchum made wide-ranging comments and spoke about structured products. Here is an excerpt of his speech:

The increasing availability of complex and sophisticated products to retail investors, while beneficial in some ways, can present challenges to a compliance department. Investors can trade exchange-traded products that provide the ability to speculate on the volatility of the securities markets or the spread between various asset classes. The structured retail products market has grown in the last few years: Over 8,000 retail structured products were sold in 2010.

The breathtaking pace of innovation and availability of these more sophisticated and complex products pose significant challenges to firms. A solid understanding of an investment product is at the core of suitability analysis and sound sales practices. I am pleased to hear that many firms are taking this challenge extremely seriously and enhancing their product training programs.

I am also pleased that some firms are establishing new control measures around their distribution processes. At the outset, firms should determine which products they are comfortable allowing their reps to sell to retail customers. Many firms have established new product committees to vet new products and determine which ones they will prohibit. The best review programs are dynamic, and require that the firm monitor market and economic conditions that could change the firm's view about the appropriateness or suitability of a particular product.

Some firms have even established additional controls with respect to those complex products they do permit. Some firms require retail customers who are interested in purchasing these complex products to complete an option account approval process. Some firms also prequalify retail customers and require them to sign specialized investor qualification agreements. These agreements may explain product features and risks in plain English, and require customers to attest to having read the materials provided, understanding the risks and wanting to invest in the product.

The challenges posed by the growth of these products affect our regulatory programs as well. FINRA monitors product development for many of the same risk factors considered by firms. We look at the complexity of products, and assess the likelihood that investors and registered representatives will understand and appreciate the risks they present. We look at the transparency of key components of products, such as embedded leverage, optionality, counterparty risks, and fees and expenses that raise concerns.

This analysis helps us better understand where emerging risks may arise and identify opportunities to provide guidance to firms and educational materials to investors. You can learn more about new and complex products from the panel later this morning.

Effective supervision is rooted in a thorough understanding of the product risks, coupled with robust broker training regarding the clients for whom the product is appropriate. Brokers cannot rely on firm approval alone to satisfy their suitability obligations. This is particularly important with the proliferation of increasingly complex financial products, and at a time when certain investors are tempted to chase yield in today's low interest rate environment.

Ketchum's comments echo the themes included in many of FINRA's recent Notices to Members as well as in FINRA's statements relating to enforcement actions in the structured products area, including the focus on suitability, new product approval processes, training, plain English disclosures that are fair and balanced, and effective supervision.

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## Why So Many Opinions? Exhibit 5.1 Opinions

The SEC rules and guidance require an unqualified "validity opinion" (an exhibit 5.1 opinion delivered by issuer's counsel) to be filed by the issuer in connection with each registered shelf takedown, including, for frequent issuers, takedowns conducted pursuant to a medium-term note program or other continuous offering program. The SEC's interpretation on this is in its Compliance and Disclosure Interpretation:

### Question 212.05

*Question:* Can a registration statement under Rule 415 be declared effective without an opinion of counsel as to the legality of the securities being issued when no immediate sales are contemplated?

*Answer:* No. However, when sales are not expected in the near future, the registrant may file a qualified opinion of counsel and have its registration statement be declared effective, subject to the understanding that an unqualified opinion will be filed no later than the closing date of the offering of the securities covered by the registration statement. An updated opinion of counsel with respect to the legality of the securities being offered may be filed in a Form 8-K report rather than a post-effective amendment to a Form S-3 shelf registration statement. This position is limited to opinions of counsel regarding the legality of the securities being offered, which are required to be filed in connection with shelf takedowns. [Aug. 14, 2009]

Historically, counsel working with issuers that used their shelf registration statements in connection with proposed sales on a delayed basis of various types of securities or in connection with medium-term note programs, filed qualified 5.1 opinions at the time of the shelf filing. For frequent issuers, some of which have almost daily takedowns of securities, the above-referenced Staff guidance had largely been observed in the breach.

However, the SEC recently contacted a variety of large frequent issuers to request stricter adherence to this stated policy. Accordingly, for example, if you search recent EDGAR filings for large frequent issuers, you will find frequent Form 8-K/6-K filings containing the relevant validity opinions. Some issuers have taken the approach of filing a legal opinion with the SEC under cover of a Form 8-K containing the proper disclosures and subsequently including in each pricing supplement the unqualified validity opinion.

Issuers will need to make certain that the correct corporate and related diligence procedures are being followed in connection with rendering validity opinions frequently.

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## Principles Applicable to Retail Structured Products Reaffirmed

The Joint Associations Committee on Retail Structured Products recently republished principles for managing the provider-distributor relationship (PD Principles) in retail structured products and principles for managing the distributor-individual investor relationship (DI Principles). The PD Principles and DI Principles were originally published in July 2007 and July 2008, respectively. The Principles may be accessed at <http://www2.isda.org/asset-classes/structured-products/>. The Principles address many issues frequently encountered by issuers and distributors of structured products. Although the Principles were originally drafted prior to the financial crisis, they remain relevant to market participants today.

## Summary of Key Issues from Recent FINRA Fines

### Introduction

FINRA's April 2011 announcements of its actions against two broker-dealers<sup>1</sup> received substantial attention in the structured products industry. In particular, these actions provide useful guidance as to the types of issues that are of most concern to FINRA in connection with its review of the structured products sales process.

This article attempts to summarize the core issues presented in these two cases. The tables below describe the key issues that FINRA identified, and may be used to assist broker-dealers in their review of FINRA's actions and whether they provide guidance for their operations. In some situations, changes or improvements may be advisable.

FINRA Rules and Guidance	Practice at Issue	Potential Items to Review
New Product Review (Notice to Members 05-26)	No process to review or approve any particular product prior to offering. (Santander Consent, page 4.)  Offerings of structured products issued by mutual funds were not presented to the new product committee. (Santander Consent, page 7.)	Confirm that an appropriate new product approval process exists, is used, and is determined to be effective.
Suitability (NASD Rule 2110)	Insufficient suitability guidance for the sales force.  No specific limits; no guidance or recommendations as to which clients were appropriate.  No guidelines as to appropriate levels of concentration in structured products.  Identification of specific unsuitable sales which resulted in customer losses.  (UBS Consent, page 4; Santander Consent, pages 4-6.)	Ensure that appropriate suitability guidelines exist for the sale of structured products, including limitations on their purchase and concentration of products in a particular investor's account.
Supervision of Sales (NASD Rule 3010)	Inadequate training, guidance and supervision of structured product sales. (UBS Consent, pages 3 and 7; Santander Consent, page 4.)  No guidance or tools for managers to use to determine suitability, and no tools to identify concentration in an investor's	Review policies and procedures for sales of structured products. Not only is the policy itself relevant, but the effectiveness of the policy in practice remains relevant.

<sup>1</sup> The UBS consent (the "UBS Consent") may be found at: <http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123478.pdf>. Our summary of the UBS Consent may be found in *Structured Thoughts*, Volume 2, Issue 4: <http://www.mofo.com/files/Uploads/Images/110414-Structured-Thoughts.pdf>. The Santander consent (the "Santander Consent") may be found at: <http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123490.pdf>.

FINRA Rules and Guidance	Practice at Issue	Potential Items to Review
	<p>account. (Santander Consent, page 5.)</p> <p>Systems for manager to conduct suitability review were viewed as slow, inefficient and impractical. (Santander Consent, page 5.)</p> <p>Failure to adequately address accounts identified as concentrated in a particular reverse convertible. (Santander Consent, page 5.)</p> <p>Failure to supervise pledge collateral accounts. No policies to govern how recommendations to purchase using these accounts would be monitored. (Santander Consent, pages 6-7.)</p> <p>Mutual fund products sold to accredited investors without a procedure to ensure that investors received offering documents, or properly executed representation letters. Practice resulted in sales to non-accredited investors, and who were not resident in an appropriate jurisdiction. (Santander Consent, page 7.)</p>	<p>Ensure that account opening procedures are being observed, and required questionnaires and agreements are being obtained.</p>
Offering Documents (NASD Rule 2110)	<p>Offering materials provided to investors that were allegedly misleading about the nature of "principal protection." (UBS Consent, page 5.)</p> <p>Offering materials not updated to reflect increasing UBS credit risk. (UBS Consent, page 6.)</p> <p>Mutual fund structured products sold to investors without first providing offering and disclosure documents. (Santander Consent, page 7.)</p> <p>Pricing supplements provided to investors that incorrectly identify the relevant issuer. (Santander Consent, page 7.)</p>	<p>Review of informational materials provided to clients, as well as "internal-only" materials, for accuracy and fairness.</p> <p>Ensure proper mechanism exists for delivery of key offering documents to investors prior to their investment decision.</p>
Training	<p>No required training on structured products for brokers or supervisors. (UBS Consent, page 3; Santander Consent, page 4.)</p> <p>Incorrect explanatory materials provided to the sales force. Sales force misunderstood the terms of the securities. UBS Consent, page 5; Santander Consent, page 4.</p>	<p>Mandate appropriate structured product training and understanding of relevant products prior to permitting personnel to effect sales.</p>

FINRA Rules and Guidance	Practice at Issue	Potential Items to Review
Corporate Financing Rule (FINRA Rule 5110, formerly NASD Rule 2710)  Conflicts of Interest (FINRA Rule 5121, formerly NASD Rule 2720)	Public offerings without prior filings under the Corporate Financing Rule. (Santander Consent, page 8.)  Offerings involving a conflict of interest did not satisfy the necessary requirements, and Santander did not make customer-specific suitability determinations. (Santander consent, page 9.)	Review offering procedures to ensure proper filings with FINRA are made (or that an exemption from filing exists).  Review procedures for offerings involving conflicts of interest.

A number of common themes emerge from the UBS Consent and the Santander Consent. In each case, FINRA reminded broker-dealers of the need for appropriate supervisory procedures, and potentially for more rigorous suitability determinations. As alleged mis-sales of structured products continue to receive attention in the mainstream press, it is possible that additional FINRA actions of this nature may arise.

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## Upcoming Teleconference: Regulatory Initiatives Affecting Structured Products

Morrison & Foerster London partners will lead a teleconference on July 27, 2011, beginning at 11:00 a.m. EDT, to discuss regulatory initiatives affecting structured products. Investors continue to find structured products to be attractive investments. Growth in the structured products market and renewed focus on investor protection issues has led to increased regulatory scrutiny. Speakers will discuss key regulatory developments that may affect the U.S. and the EU markets for structured products, including FINRA guidance in the U.S. relating to structured products; know-your-customer; suitability and fiduciary duty issues; disclosure considerations; the potential impact of the Dodd-Frank Act on structured products; the importance of the Key Information Document; the EU Packaged Retail Investment Products (PRIPs) initiative; the FSA's Product Intervention paper in the UK; and other emerging issues.

To register, please contact Diane Kolanovic at [dkolanovic@mofo.com](mailto:dkolanovic@mofo.com).

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