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Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

The SEC's Report of Its Sweep Examination of Retail Structured Products

Introduction

As many readers know, on July 27, 2011, the SEC Office of Compliance Inspections and Examinations (OCIE) issued a summary report identifying common weaknesses that it observed in sales of retail structured products during its sweep examination in 2008 and 2009.[1] The report describes measures that broker-dealers may take to better protect retail investors from fraud and abusive sales practices. In this article, we provide an analysis and some observations about the report.

Background and Summary Findings and Recommendations

The report summarizes the results of the SEC's sweep examination of the retail structured products business of 11 different broker-dealers, which cover a cross-section of the industry.

Among other things, the staff observed that, during the relevant period, broker-dealers might have:

- Recommended unsuitable structured products to retail investors;

[1] The report may be found on the SEC's website at: http://www.sec.gov/news/studies/2011/ssp-study.pdf. The SEC's press release announcing the report may be found at: http://www.sec.gov/news/press/2011/2011-157.htm.

- Traded structured products at prices that were disadvantageous to retail investors;
- Omitted material facts about structured products offered to retail investors;
- Engaged in questionable sales practices with customers; and
- Did not maintain adequate supervisory and training requirements.

The report recommends that larger broker-dealers should focus on the following issues:

- Having adequate procedures and controls to prevent and detect possible abuses in the secondary market for structured products;
- Appropriately disclosing material facts regarding structured products;
- Requiring registered representatives and their supervisors to complete specialized training in these instruments before selling them to customers;
- Accurately listing structured products on customer statements;
- Establishing controls to independently review their desk prices of structured products in the secondary market;
- Having controls to adequately review the suitability of these products for customers; and
- Having controls to review customer concentrations in the structured products it sold.

The staff report states that smaller retail broker-dealers should focus on:

- The suitability of structured products recommended to retail customers;
- Establishing, maintaining and enforcing proper supervisory procedures relating to suitability determinations for purchasers of structured products; and
- Having adequate training for registered representatives who sell structured products and for their supervisors.

Discussion

As we note above, the report was issued by the staff of the OCIE, which regularly conducts examinations of broker-dealers. The OCIE's examinations are principally intended to test the broker-dealer's compliance with the federal securities laws and regulations. The OCIE frequently consults with other staff within the SEC and with other divisions concerning matters that arise during its field examinations. From time to time, when the OCIE identifies compliance or internal control issues of a serious nature, the OCIE may refer the matter to the Division of Enforcement. The OCIE may also raise issues with the Division of Trading and Markets or the Division of Corporation Finance. The OCIE is one of several groups within the SEC that has been focused on the structured products market.

Given the growth of the retail structured products market that are in the United States, the OCIE reviewed the retail business of 11 broker-dealers, including three that are affiliated with bank holding companies that are structured products issuers, a wholesaler that sells structured product through other broker-dealers, and seven smaller retail firms that also distribute third-party structured products. The examinations were conducted principally in 2008 and 2009 and included participation by the OCIE's regional offices in New York and Chicago.

In large measure, many of the issues noted in the report are issues with which market participants are quite familiar, given that there has been significant activity by FINRA and by other regulators during recent years related to structured products. In fact, the report cites various FINRA notices or alerts, including the 2005 NASD Notice to Members (05-59) on structured products, as well as prior guidance relating to "non-conventional investments"

(Notice to Members 03-71) and new products (Notice to Members 05-26). The report also cites the more recent FINRA guidance on reverse convertibles (Regulatory Notice 10-09).

Suitability

In recounting the observations made during the examinations, the report tracks closely the requirements that were included in Notice 05-59. The report notes that the most significant weaknesses observed related to suitability issues in connection with the sale of reverse convertibles. In its comments on suitability, the report appears to adopt the procedure originally highlighted in Notice 05-59 of requiring option trading approval for customers purchasing structured products. However, the report does not track the significant caveat made in the original Notice to Members, which included an observation that options trading approval was but one possible approach to addressing suitability determinations. If a firm does adopt the options trading approval process, then, of course, it must take care to implement appropriate procedures.

Concentration Risks

Consistent with various FINRA actions, the report notes that concentration issues require close attention and suggests that reports on customer concentration in structured products "may be a beneficial practice." The report appears to note favorably the fact that two of the reviewed originating firms have monthly exception reports that review for customer concentration. Market participants should focus on their policies and procedures and technology for monitoring concentration issues.

The focus on an investor's concentration in structured products is reminiscent of the concerns raised by FINRA in its February 2010 fine of H&R Block for sales of reverse convertible notes.[2] There, FINRA recommended that brokers maintain procedures to monitor customer accounts for concentration of these products.

Neither FINRA nor the SEC have defined what would constitute appropriate levels of concentration in structured products, or in different kinds of structured products. However, for purposes of evaluating account concentration, both of them seem interested in the possibility of treating structured products (or different types of structured products) as an asset class. Such treatment would raise a variety of issues for brokers, including:

- To what extent does a concentration in structured products interact with related concentration issues (which may offset to some extent the concentration in structured products), such as concentration of a portfolio in a small number of issuers, concentration in a small number of asset classes or exposure to a limited number of stocks?[3]
    - To what extent is concentration an issue, if an investor's structured product investments are not concentrated in particular structured product issuers (and their credit risk) or in the same asset class?
    - If an investor has a high concentration even in a particular type of product, such as reverse convertibles, to what extent is it problematic if the instruments are issued by a variety of issuers, and with a set of underlying stocks that reflects the investor's investment view?
- What systems or other procedures are needed to monitor concentrations in structured products?

Disclosure Issues

The report raises concerns regarding disclosures relating to "principal protection." Given the extraordinary attention that this issue has attracted in the aftermath of the failure of Lehman Brothers, we believe that it is well understood by market participants. Due to concerns that have arisen over this issue, most market participants have attempted

[2] See http://www.finra.org/Newsroom/NewsReleases/2010/P120914.
[3] That is to say, for example, that if an investor's portfolio consists 50% of stock ABC and 50% of a reverse convertible issued by bank XYZ that is linked to stock ABC, the investor has 100% concentration of exposure to stock ABC.

during the past few years to enhance and improve the disclosures in their offering documents as to issuer credit risk. The staff also notes disclosure concerns related to fees.

As compared to, for example, the SEC's Division of Corporate Finance, the OCIE has been less active in reviewing the content of disclosure documents. We would anticipate that other groups at the SEC could express in the future a view or preference as to other disclosures in structured product offering documents that market participants consider important, including risk factors, conflict of interests, and related items.[4]

Secondary Market Concerns

The report devotes substantial attention to secondary market issues, while acknowledging that structured products are designed as buy-and-hold investments, and that there is limited secondary market trading. Examiners noted that at most firms, trading desk prices are reviewed by an internal control group that is independent of the trading desk. Specifically, the staff notes that there should be a control to ensure fair pricing.[5] At another firm, the lack of an independent review of the trading desk's prices was identified as an internal control weakness. The staff also noted a number of other weaknesses or inadequacies related to secondary trading, including that:

- Firms do not review customer trades that occur soon after issuance;[6]
- Firms do not review customer sales near maturity;[7]
- The commissions charged on secondary activity often greatly exceed the charge at issuance and exceed the firm's applicable guidelines; and
- Firms do not review secondary activity for "possible switching, despite the high incentive for registered representatives to switch customers from one [structured product] to another."

Training

Again, consistent with recent FINRA actions, the report noted that a few of the firms did not have specific training requirements in place for registered representatives active in structured products, and none had training requirements in place for the supervisors of the registered representatives that market structured products. For those firms that did have training programs, there were deficiencies cited relating to structured product sales.

Next Steps

Given the growth in the market, we anticipate that regulatory scrutiny is likely to intensify. Although there are only a handful of new issues raised in the OCIE report, the report is another indication of the level of attention being paid to this segment of the market. The report also provides important reminders for broker-dealers regarding the need to revisit their policies and procedures, especially as these relate to retail structured products. Carlo di Florio, Director of the OCIE, notes, "This report could help companies strengthen their compliance programs to better address the issues [the OCIE] observed during [the] sweep and in subsequent exams."

And as a "heads up" that more may be to come, Mr. di Florio added, "Beyond this report, we are monitoring the way in which these products evolve, and are considering additional steps in the near future relating to structured securities products that may further bolster investor protection."

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[4] Representatives of these groups have indicated an interest in these matters at industry conferences and in other contexts.
[5] As a potential example of an unfair price, the report refers to purchases that were effected for customers at prices that exceeded the maximum return price of the structured product on the applicable call date.
[6] For example, a sale by an investor shortly after issuance could raise issues as to (a) whether the initial sale was suitable for that investor or (b) if the sale is made at a discount to par, whether the initial offering price reflects a reasonable price.
[7] Near maturity, the final return of the structured product may be known, or estimated with a higher degree of reliability. Accordingly, a sale at a substantial discount from that price could raise questions as to the fairness of the sale price.

RIC Commodity Ruling Update

We learned last week that the Internal Revenue Service ("IRS") has imposed an informal moratorium on private letter rulings for regulated investment companies ("RICs") that invest in commodities through foreign subsidiaries or structured notes, presumably because the government is reconsidering the tax issues involved. There is no way to tell how long the moratorium will last, or whether the IRS will change its position on issuing these rulings—to date, more than 50 have been issued.

Background

Almost all mutual funds are formed as RICs under the Internal Revenue Code of 1986 ("Code"). To qualify as a RIC, an entity must (i) be domestically organized, (ii) be registered under the Investment Company Act of 1940, (iii) meet an asset test,[8] (iv) meet an income test,[9] and (v) elect to be taxed as a RIC.

In Rev. Rul. 2006-1,[10] the IRS ruled that a commodity swap produced "bad," i.e., non-qualifying RIC income. In response to industry concern that Rev. Rul. 2006-1 precluded any commodities exposure for a RIC, in April 2006 the IRS issued what is now known as the "Rydex ruling." The Rydex ruling concluded that (i) if a RIC formed a foreign corporation that bought commodities and entered into commodities swaps, then even though the commodity investments (if held directly) produced "bad" RIC income, the stock of the foreign corporation would be a "good" RIC asset that produced "good" RIC income[11] and that (ii) a structured note that gave a RIC exposure to commodities was a "security" under the Investment Company Act of 1940 and, therefore, was a "good" RIC asset that produced "good" RIC income.

Earlier versions of the recently passed RIC Modernization Act of 2010 (the "Act") contained a provision permitting RICs to invest directly in commodities, but the final version of the Act did not.

Current Developments

While the IRS has temporarily suspended issuance of RIC commodities rulings like those described above, the IRS has not made any formal announcement nor has it added the RIC commodities issues to the "no-rule list." Apparently, the IRS will accept ruling requests that are filed; however, it is unclear when (if ever) such ruling requests will be acted upon. Moreover, no action has been taken to revoke currently outstanding private letter rulings.[12] While there is speculation about the government's reasons for the moratorium, the specific reasons for the action (or better, the inaction) are unclear.

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[8] In general, the asset test requires that a RIC diversify its holdings so that, at the end of each quarter of each taxable year (i) at least 50% of the market value of the RIC's total assets is represented by cash and cash items, U.S. government securities, the securities of other RICs and other securities, with other securities limited, in respect of any one issuer, to an amount not greater than 5% of the value of the RIC's total assets and not more than 10% of the outstanding voting securities of such issuer (subject to certain exceptions), and (ii) not more than 25% of the market value of the RIC's total assets is invested in the securities of any issuer (other than U.S. government securities and the securities of other RICs), the securities of any two or more issuers that the RIC controls and that are determined to be engaged in the same business or similar or related trades or businesses, or the securities of one or more "qualified publicly traded partnership" (QPTPs).

[9] In general, the income test requires that at least 90% of the RIC's annual gross income must consist of dividends, interest, payments with respect to certain securities loans, gains from the sale or other disposition of stock, securities or foreign currencies, other income (including but not limited to gain from options, futures and forward contracts) derived with respect to its business of investing in stock, securities or currencies, or net income derived from an interest in a QPTP.

[10] 2006-1 CB 261 (Dec. 16, 2005).

[11] The foreign corporation itself was not subject to U.S. federal income tax because it qualified for the commodities trading safe harbor. See IRC § 865(b)(2)(B).

[12] Taxpayers that have relied on a ruling would likely argue they should be "grandfathered" were the IRS to attempt to revoke their rulings.

In re Lehman Brothers and Principal Protection

On July 27, 2011, Judge Lewis Kaplan issued a ruling in the case In re Lehman Brothers Securities and ERISA Litigation, in which the plaintiffs include pension funds, companies and individuals that were purchasers of various classes of equity and debt securities issued by Lehman Brothers Holdings Inc.[13] The claims relating to approximately 50 series of Lehman principal-protected notes had previously been consolidated with this case involving other securities. Among other claims, the plaintiffs allege that the offering materials related to the principal-protected notes were "materially misleading because they promised but did not provide 'principal protection'."

Judge Kaplan's decision addressed a number of matters relating to the issuer's disclosures and other issues raised in the litigation. In respect of the principal-protected notes, the decision notes that none of the named plaintiffs actually purchased securities in the principal-protected notes offerings, and as a result have no standing to bring Section 10(b) and Rule 10b-5 claims in respect of offerings in which they did not purchase securities. However, the Court concluded that the plaintiffs' other allegations in respect of the principal-protected notes were sufficient to state a claim and should be allowed to proceed. Plaintiffs argued that the statements included in the offering materials were "false and misleading because (1) the PPNs did not protect investors' principal and were no different than ordinary bonds, and (2) the PPN Offering Materials failed to disclose that repayment of principal depending on Lehman's solvency." Although the Court noted that there were disclosures regarding credit risk and that the "statements would have made the nature of these securities clear to a careful and intelligent reader," on balance the statements regarding principal protection were more prominent and frequent than the statements regarding Lehman credit risk.

The Court was addressing a motion to dismiss for failure to state a claim, and was not resolving the question of whether the Lehman Brothers offering documents were in fact misleading as a matter of law. However, the decision serves as another warning to market participants that disclosures about "principal protection" must be appropriate and balanced. Disclosures as to the related credit risk of the issuer that investors face should be as prominent, or even more so. Issuers and underwriters of structured products have been making an effort to do so during the last several years, and it remains advisable to be cautious about these disclosures.

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[13] The decision may be found at: 2011 U.S. Dist. LEXIS 82119.

Morrison & Foerster named Structured Products Firm of the Year, Americas, 2011 by *Structured Products* magazine.

Morrison & Foerster short-listed as *Derivatives Week* magazine's 2011 Law Firm of the Year. The winner will be revealed at a ceremony on September 27, 2011.

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