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REVERSE inquiries

Structured and market-linked product news for inquiring minds.

Unsuitable Sales of Leveraged ETFs Draw FINRA's Ire; Text Messaging Violates Communications Rules

The Financial Industry Regulatory Authority, Inc. ("FINRA") has been quite clear on its views of "non-traditional exchange traded products," such as leveraged inverse exchange-traded notes ("ETNs") and exchange-traded funds ("ETFs"). Because these products have features such as inverse leverage and daily resets, FINRA views these products as unsuitable for retail investors who plan to hold them for more than one trading session, particularly in volatile markets.[1] Consequently, when member firms or their personnel fail to heed this advice, such as when selling these products to retail investors, allowing those investors to hold these in their accounts for extended periods of time and failing to supervise, or failing to enforce written supervisory procedures intended to prohibit such sales, FINRA has taken action. In a recent trio of cases, similar sets of facts brought FINRA enforcement proceedings. The salient points of one pair of related cases were these:

- Member firms failed to establish, maintain and enforce a supervisory system reasonably designed for the review of transactions in non-traditional ETFs;
- Supervisory procedures were written, but not enforced;
- Representatives were not trained regarding the risks of non-traditional ETFs;
- No written materials were created to provide guidance to representatives on determining suitability of recommendations of non-traditional ETFs;
- No exception reports or other procedures were in place for reviewing the holding periods of non-traditional ETFs.[2]

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[1] *See* FINRA Regulatory Notice 09-31, "Non-Traditional ETFs" (June 2009).

[2] *See* Parkland Securities, LLC, case no. 2016052300601 and Sigma Financial Corporation, case no. 2016052300602.

These facts were exacerbated by the firms' telling their FINRA examiners that they were implementing corrective actions, but not actually doing so. In both cases, customers held the non-traditional ETFs for extended periods of time, in some case up to two years. Consequently, both firms violated FINRA Rule 3110, which requires broker-dealers to establish and maintain a supervisory system, including written supervisory procedures, reasonably designed to achieve compliance with applicable securities laws, regulations and rules. The firms also violated FINRA Rule 2010, which requires a member, in the conduct of its business, to observe high standards of commercial honor and just and equitable principles of trade.

In a similar case involving sales of non-traditional ETFs and ETNs, and violations of the same FINRA rules, the member firm failed to ensure the suitability of recommendations to its customers of such products or to ensure that customer files contained letters or e-mails memorializing discussions of the relevant risks and volatility of the ETFs and ETNs with the customers before they invested in those products.[3]

In a separate case, a registered representative communicated with customers and conducted securities business through text messaging, in violation of the member firm's written procedures. These actions violated FINRA rules requiring a member firm to review and retain public communications and making and preserving books and records, as required by FINRA Rule 2210(b).[4]

OCIE's Retail Investor Protection Focus

On April 29, 2019, Securities and Exchange Commission ("SEC") Office of Compliance Inspections and Examinations ("OCIE") Director Peter Driscoll delivered a speech[5] on the OCIE's 2019 priorities, in which he identified, among other priorities, the following:

1. *Fees, Expenses and Related Disclosures*. Examiners are evaluating whether investors are receiving accurate information about fees and expenses. They closely review a firm's disclosures and compare these with actual practice. Examiners also check if the adviser's billing frequency and its application of fee rate, rebates, breakpoints and discounts are consistent with the advisory agreement.

2. *Safeguarding Client Assets*. OCIE has been focusing on compliance with Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Custody Rule"), which requires that advisers that have custody of client assets (1) hold clients' funds and securities at a qualified custodian, using a separate account for each client under that client's name (or in the adviser's name as agent or trustee for the client); (2) notify clients about item (1) and whenever there are any changes made; (3) have a reasonable basis that the qualified custodian sends account statements to clients at least quarterly; and (4) undergo an annual surprise examination or use an approved alternate approach.

3. *Conflict of Interest Disclosure.* Section 206 of the Advisers Act imposes on an adviser a fiduciary obligation. An adviser should fairly deal with present and prospective clients and fully disclose any material actual or potential conflict of interest that exists. Examiners review an adviser's disclosures in

[3] *See* Corinthian Partners, LLC, case no. 2016047621801.

[4] *See* Farrukh S. Kazmi, Order Accepting Offer of Settlement (Mar. 22, 2019).

[5] *Available at* http://bit.ly/2JXyYrE.

connection with its operations to evaluate whether the adviser has appropriately identified and disclosed conflicts.

4. *Senior Investors.* OCIE reviews advisers with a significant senior client base to check if appropriate policies and procedures that address senior investor protections are in place.

While a number of these are more focused on advisers, the underlying themes are applicable to broker-dealers.

Department of Labor Fiduciary Rule Update

In March 2018, the U.S. Fifth Circuit Court of Appeals vacated the U.S. Department of Labor ("DOL") final 2016 regulation under Section 3(21) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") on investment advice fiduciary status, thus eliminating the DOL's fiduciary rule.

In a hearing held by the House Education and Labor Committee in early May 2019, Labor Secretary Alexander Acosta said that the DOL plans to reenact its fiduciary rule. The DOL is coordinating its work with the SEC, which is finalizing Regulation Best Interest. It is not clear when a new DOL fiduciary rule will be released as Mr. Acosta declined to offer a time line during a Q&A in the hearing.

House Passes Resolutions on Financial Literacy and Support for Elderly

On April 30, 2019, the U.S. House of Representatives passed H. R. 328, *Supporting the Protection of Elders Through Financial Literacy* and H.R. 1876, *the Senior Security Act of 2019*.

H.R. 328 supports efforts to combat senior financial exploitation through financial literacy. The resolution (1) supports the goals of "Financial Literacy Month" to raise public awareness about the importance of personal financial education in the United States and the serious consequences that may result from a lack of understanding about personal finances; (2) acknowledges that raising awareness of threats to personal finances, especially for targeted populations like older adults and their relatives and caregivers, is only one part of financial literacy; and (3) understands that to combat elder financial exploitation, it is also necessary to encourage continued collaboration among law enforcement, financial institutions, regulatory agencies, and private sector organizations allowing detection, prevention, reporting, and investigation of these crimes.

H.R. 1876 aims to strengthen efforts to protect elderly investors from financial exploitation. H.R. 1876 creates a new SEC taskforce charged with identifying problems senior investors encounter, including financial exploitation and cognitive decline, and identifying regulatory changes that could help protect senior investors. Pursuant to H.R. 1876, the new SEC taskforce would report to Congress every two years on key observations, best practices, and areas for improvement identified throughout its work. Moreover, within one year of its enactment, the U.S. Government Accountability Office would be required to study and report on the economic costs of the financial exploitation of senior citizens.

Keeping with the trend of combating senior financial exploitation, on May 8, 2019, the SEC published a paper entitled, "How the SEC Works to Protect Senior Investors." The paper reviews the SEC's education, examination, and enforcement efforts; discusses the SEC's regulatory policy initiatives related to the protection of senior investors; and describes the challenges facing the SEC in its work to protect senior investors.

Both bills will now move to the Senate. As of May 2019, H.R. 1876 was received by the Senate, read twice and referred to the Committee on Banking, Housing and Urban Affairs.

Revised Notice of Proposed Rule Change to FINRA Rule 5110

FINRA recently refiled its proposed rule change to amend FINRA Rule 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements). FINRA previously filed, and later withdrew, a proposed rule change to amend FINRA Rule 5110 in October 2018, which we discussed in a Legal Update at that time. The updated proposal reflects only minor updates from the October 2018 proposal and continues to include changes to (1) general filing requirements; (2) filing requirements for shelf offerings; (3) exemptions from filing and substantive requirements; (4) underwriting compensation; (5) venture capital exceptions; (6) treatment of non-convertible or non-exchangeable debt securities and derivatives; (7) lock-up restrictions; (8) prohibited terms and arrangements; and (9) defined terms. These changes are substantially as described in the prior proposed rule change and Legal Update except that, after comments to the prior proposal, FINRA is no longer proposing to eliminate the itemized disclosure of underwriting compensation or the three percent non-accountable expense cap. Of particular note to structured products issuers are the revisions to the exemptions to the FINRA filing requirements, the treatment of derivatives acquired in connection with public offerings, and the revised definitions.

Most structured note issuers currently rely on either the pre-1992 Form S-3 or F-3 eligibility criteria exemption or the investment grade debt exemption to the FINRA filing requirements, both of which have been modified by the proposed rule. The proposed rule removes the reference to Forms F-3 and S-3 and defines an "experienced issuer" as an issuer with a 36-month reporting history and at least $150 million aggregate market value of voting stock held by non-affiliates or, alternatively, an aggregate market value of voting stock held by non-affiliates of at least $100 million and an annual trading volume of three million shares. The proposed rule also expands the investment grade debt exemption to explicitly include banks; however, the definition of a "bank" has also been modified (discussed further below).

The proposed rule also addresses the treatment of derivatives in the context of underwriting compensation and the lock-up provisions. Specifically, it clarifies that derivatives that are acquired in transactions related to public offerings, such as in hedging transactions related to structured notes offerings, are underwriting compensation and, for offerings that are subject to the FINRA filing requirements, a description of the derivative instruments and a representation that the derivatives transaction was executed at a fair price must also be filed with FINRA. Additionally, the proposed rule clarifies that derivatives acquired at a fair price, while considered underwriting compensation, would not be considered to have any compensation value and therefore their value would not need to be disclosed in the applicable prospectus. Derivatives acquired at a fair value in connection with a public offering are also explicitly exempt from Rule 5110's lock-up provisions under the proposed rule. The term “public offering” as it is used in both the underwriting and lock-up provisions has been modified as part of the new consolidated definitions.

The revised rule provides a consolidated set of definitions, including the terms “bank” and “public offering,” with the intent of creating consistent definitions across Rule 5110’s provisions. “Bank” has been defined by reference to Section 3(a)(6) of the Exchange Act and to include only those foreign banks which have been specifically granted an exception from FINRA under Rule 5110, and it does not include branches or agencies of foreign banks. As a result, the investment grade debt exemption commonly relied upon by non-U.S. issuers of structured notes, would only be available under the proposed rule to those foreign banks which have received an exception from FINRA. Branches and agencies of foreign banks, which have relied on the conditions in the SEC’s 1986 no-action letter (Release 33-6661 (Sept. 23, 1986)) to be within the exemption from registration under the Securities Act of 1933 provided by Section 3(a)(2) thereunder in order to be treated on an equal footing with U.S. banks, would now have to apply to FINRA for an exception from Rule 5110. The term “public offering” has also been revised to exclude offerings exemption from SEC registration pursuant to Regulation S or Rule 144A, explicitly clarifying that these offerings are exempt from Rule 5110.

The full text of the proposed rule change is available here. The notice of the proposed rule change appeared in the Federal Register on May 1, 2019 and the SEC comment period expired on May 22, 2019. The status of this proposed rule change may be monitored via FINRA’s Rule Filing Status Report.

Refresher: Using Free Writing Prospectuses for Structured Notes Offerings

With the SEC’s Securities Offering Reforms in December 2005 came a new tool for offering securities: the free writing prospectus. No longer would an issuer be required to satisfy all of the form requirements of Regulation C under the Securities Act of 1933 (the “Securities Act”), as required when using a prospectus supplement or preliminary pricing supplement. The free writing prospectus (“FWP”) was designed to allow more flexibility for issuers and underwriters.

When first introduced, it was generally accepted that the point of the FWP was to address the need for disclosures that didn’t neatly fit into, or require, a full prospectus meeting all of the SEC’s form requirements. Prior to December 2005, these types of disclosures were known as “free writings,” and permissible uses were extremely limited.

The new FWP allowed for free writings, within the provisions of Rule 433 under the Securities Act. For example, a brief FWP might be filed to add some small piece of new material information that had come up after the initial filing of the preliminary pricing supplement, or to correct an error. In the context of a medium-term note program using a shelf registration statement, a one-page FWP could be used without filing if it contained only the preliminary terms of an offering, and another one-page FWP could be filed with the final terms of the offering. These FWPs would be delivered with the underlying base prospectus and any prospectus supplement and preliminary pricing supplement. In each case, the FWP would not have to satisfy the requirements of Regulation S-K Items 501-509, but instead meet the requirements of Rule 433. Provided that the FWP contained the required legend under Rule 433(c)(2)(i), the form and content of the FWP were essentially wide open, as compared to a preliminary pricing supplement. In practice, FWPs used in offerings of structured notes tend to look suspiciously like preliminary pricing supplements, generally meeting the Regulation S-K requirements to the letter.

FWPs are very important for offerings of structured notes. In addition to the underlying base prospectus, prospectus or product supplement (if any) and preliminary pricing supplement, distribution participants will also use fact cards for a particular offering, or even materials not related to any particular security. For example, if an affiliate of an issuer or underwriter is the administrator of a proprietary index underlying the issuer's structured note, there may be explanatory materials about the index (which may include backtesting) that the underwriter or dealer may use in conjunction with the securities-related offering materials. Depending on how these materials are used, a regulator could deem these to be FWPs.

Issuers and underwriters, particularly affiliated underwriters, may also produce generic materials describing particular structures, or even "educational" materials, designed to be provided to investors and used as part of a structured notes offering program, even though the materials do not relate to any particular security. Again, depending on how these materials are used, they could, in hindsight, be viewed as FWPs.

LIABILITY

But pity the poor underwriter that wants to use a FWP. With the flexible disclosure option came liability. Underwriters using a FWP are subject to liability under Section 12(a)(2) of the Securities Act. Under Rule 159A(b)(1) under the Securities Act, it is difficult for an underwriter using a FWP to escape liability under Section 12(a)(2) of the Securities Act if the FWP contains a misstatement or omission.

That section reads:

Definition of by Means of for Purposes of Section 12(a)(2) of the Act. (1) For purposes of section 12(a)(2) of the Act only, an offering participant other than the issuer shall not be considered to offer or sell securities that are the subject of a registration statement by means of a free writing prospectus as to a purchaser unless one or more of the following circumstances shall exist:

(i) The *offering participant used or referred to the free writing prospectus* in offering or selling the securities to the purchaser;

(ii) The offering participant offered or sold securities to the purchaser and *participated in planning for the use of the free writing prospectus by one or more other offering participants* and such free writing prospectus was used or referred to in offering or selling securities to the purchaser by one or more of such other offering participants; or

(iii) The offering participant was required to file the free writing prospectus pursuant to the conditions to use in Rule 433. [Emphasis added.]

In short, under the Rule 159A liability scheme, an underwriter that "uses or refers to" a FWP or "participates in the planning for the use of the FWP" in an offering with other offering participants will be liable under Section 12(a)(2) of the Securities Act if the FWP contains a material misstatement or omission.

For issuers, Rule 159A fastens liability by stating that any free writing prospectus "prepared by or on behalf of the issuer or used or referred to by the issuer" causes the issuer to be a "seller" for purposes of liability under

Section 12(a)(2) of the Securities Act in an initial distribution of the securities. The note to Rule 159A(a) states that "information is provided or a communication is made by or on behalf of an issuer if an issuer or an agent or representative of the issuer authorizes or approves the information or communication before its provision or use."

These provisions raised many questions:

- For an issuer, where does "authorize or approve" begin and end?
- For underwriters, what does "used or referred to" mean?
- For underwriters, what constitutes "participated in planning for the use of the FWP"?

Issuers and underwriters regularly review each other's communications to investors, generally for the purpose of correcting errors and improving clarity. During this process, there are multiple communications between issuers and underwriters, with multiple drafts of the communication being improved along the way.

Rather than engage in hair-splitting about whether any activities fall into the Rule 159A liability traps, issuers and underwriters developed several practical responses to these questions, all for the purpose of establishing ownership of the FWP.

In underwriting and distribution agreements, issuers and underwriters generally agree that only the issuer will create an issuer free writing prospectus, to be approved by the lead underwriter. In the case of distribution agreements used in structured notes offerings, the issuer creates the issuer free writing prospectus and its affiliated broker-dealer approves the form before use. In dealer agreements between an underwriter and a downstream selected dealer, generally the downstream dealer will be prohibited from creating FWPs. If a downstream dealer has the ability to create FWPs, it will indemnify the underwriter for claims arising from those FWPs.

Liability is also somewhat limited by the practice of conforming structured notes FWPs to the form requirements of Regulation S-K.

ISSUER FWP OR UNDERWRITER FWP?

These provisions prevent the creation of a FWP whose paternity may be disputed. However, these provisions do not clarify who is liable for the agreed-upon FWP when one or both parties have reviewed, commented on, approved and used the FWP.

The solution to this problem is to have the issuer take ownership by filing the FWP as an "issuer free writing prospectus" in almost every situation.[6] This is the case even though there may be a clear exemption from filing for some FWPs or the FWP may have been originated by the broker-dealer affiliate of the issuer. This also comports with the general theme of allocation of liability in underwriting agreements – the issuer is getting the most benefit from the offering, and therefore should bear a proportionately larger part of the potential liability.

Even though Rule 433(d)(5)(i) provides an exemption from filing for FWPs that do not contain the final terms of an offering, market practice is that a structured notes issuer using a FWP within this exemption from filing instead of a preliminary pricing supplement will file the FWP as an issuer free writing prospectus. An

[6] *See* Rule 433(h)(1); issuer FWPs are required to be filed under Rule 433(d)(1)(i).

agreement by an issuer to file a FWP will be built into the terms of a distribution agreement for structured products. Why would an issuer do so when there is a clear filing exemption available?

When Rule 433 was adopted, there were some open questions for which practitioners didn't have easy answers. For example, if an underwriter or two had their names on the bottom of a FWP for an issuer's offering, would that make that FWP an "underwriter free writing prospectus," for which the underwriters would take liability, instead of the issuer? The filing requirement in Rule 433(d)(1)(ii) states that "any offering participant, other than the issuer, shall file any free writing prospectus that is used or referred to by such offering participant and distributed by or on behalf of such person in a manner reasonably designed to lead to its broad unrestricted dissemination." A FWP used in any offering of securities would have a broad unrestricted dissemination. Most underwriters are not, and do not want to be, SEC filers.

Another question was whether a FWP created by an underwriter affiliated with an issuer for an offering of the issuer's securities would be viewed as an underwriter free writing prospectus or an issuer free writing prospectus.

By filing FWPs as issuer free writing prospectuses, any named underwriter escapes the Rule 433(d)(1)(ii) filing requirement and also the related FINRA Rule 2210(c)(7)(f) filing requirement. Representatives of FINRA have also stated in public forums that FINRA would not view an issuer free writing prospectus as "belonging" to an affiliated underwriter, and thus being a underwriter free writing prospectus, even though the FWP originated on the affiliated underwriter's desk. That is helpful because even though issuer free writing prospectuses filed with the SEC are carved out of FINRA's filing requirements for retail communications under Rule 2210(c)(7)(F), FWPs that are exempt from SEC filing (such as under Rule 433(d)(5)(i)), and underwriter free writing prospectuses are subject to FINRA's filing requirements. Any FWP that contains backtested data and is filed as an issuer free writing prospectus would also not be subject to FINRA's prohibitions of the use of such data in retail communications.

ANNOUNCEMENTS

Capital Markets Tax Quarterly. Mayer Brown's Capital Markets Tax Quarterly, provides capital markets-related US federal tax news and insights.

In our latest issue we look at Q1 2019.

LinkedIn Group. Stay up to date on structured and market-linked products news by joining our new LinkedIn group. To request to join, please email reverseinquiries@mayerbrown.com.

Suggestions? *REVERSEinquiries* is committed to meeting the needs of the structured and market-linked products community, so you ask and we answer. Send us questions that we will answer on our LinkedIn anonymously or topics for future issues. Please email your questions or topics to: reverseinquiries@mayerbrown.com.

UPCOMING EVENTS

***REVERSEinquiries* Workshop Series: New Product Governance and Post-Sale Reviews**

Please join us by webcast on **June 13, 2019**, for our latest REVERSEinquiries Workshop.
Program: 1:00 p.m. – 2:00 p.m. EDT. **Click here to RSVP**

We will discuss the elements of a new product review and governance process, as well as considerations associated with establishing and maintaining a robust post-sale review and supervisory and oversight program. Among other things, we will discuss:

- Identifying new products;
- Classifying new products;
- Constituencies that should participate in new product review;
- FINRA and other guidance;
- Post-sale review procedures; and
- Surveillance and other supervisory and oversight approaches.

Save the dates for our entire 2019 REVERSEinquiries Workshop webinars. For more information, please e-mail REVERSEinquiries@mayerbrown.com.

- October 17, 2019
  ETNs and Daily Redeemable Notes
- November 14, 2019
  Platforms and Securities Law and Commercial Considerations

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