MAYER | BROWN

VOLUME 02, ISSUE 09 | October 2, 2019

REVERSE inquiries

Structured and market-linked product news for inquiring minds.

Frequent Principal and Trading Agency Cross Transactions Compliance Issues

The Office of Compliance Inspections and Examinations ("OCIE") released a Risk Alert[1] identifying the most common compliance issues, as identified by examinations of investment advisers, related to principal and agency cross transactions under Section 206(3) of the Investment Advisers Act of 1940 (the "Advisers Act"). Section 206(3) makes it unlawful, with certain limited exceptions, for an investment adviser to directly sell or purchase securities to and from clients or to act as a broker for a third party effecting the sale or purchase of securities, without satisfying certain disclosure and consent requirements.[2] Issuers of structured investments often seek to have these investments distributed through affiliated private wealth channels and, in that context, should consider the most common compliance issues observed by OCIE staff.

Failing to follow the specific requirements of Section 206(3) was one of the most common compliance issues identified. Examples included failure to recognize that Section 206(3) applies, failure to obtain client consent before each individual trade and insufficient disclosure regarding potential conflicts of interest and transaction terms.

Compliance issues frequently arose in relation to agency cross transactions, both because advisers disclosed that they would not engage in agency cross transactions, and then did so, and because advisers effected agency cross transactions purporting to rely on Rule 206(3)-2 but did not follow the specific requirements related to the rule.

Finally, many advisers did not have policies and procedures in place relating to Section 206(3), and among those that did establish such policies, many failed to follow them.

In This Issue

[1] See OCIE Risk Alert Investment Adviser Principle and Agency Cross Trading Compliance Issues, Office of Compliance Inspections and Examinations (Sept. 4, 2019)

[2] While it is necessary for an adviser to comply with Section 206(3), compliance with Section 206(3) is not necessarily sufficient to satisfy an adviser's fiduciary obligations.

The OCIE concluded by encouraging advisers to adopt policies related to Section 206(3) and to review those policies to ensure compliance with the principal trading and agency cross transaction provisions of the Advisers Act.

FINRA Sanctions Representative and Member for Unsuitable Recommendation of Financial Product

A general securities representative settled Financial Industry Regulatory Authority ("FINRA") charges for advising customers to purchase Leveraged and Inverse Exchange Traded Funds ("LIETFs") without understanding the specific risks and unique features. The member firm with which the representative was associated also settled charges for failure to supervise. The parties executed a Letter of Acceptance, Waiver and Consent[3] (the "AWC") in early September.

According to the AWC, the representative recommended his customers hold LIETF shares for several weeks, which was contrary to published guidance on LIETFs and resulted in losses. LIETFs are considered non-traditional ETFs—they seek to deliver returns that are multiples of the performance of their underlying index or benchmark. Non-traditional ETFs are financial instruments that typically "reset" daily, meaning they are designed to achieve their stated objectives only on a daily basis. Accordingly, their performance over longer periods can differ significantly from their stated daily objective. Non-traditional ETFs that reset daily typically are unsuitable for retail investors who plan to hold them for longer than one trading session.

FINRA Regulatory Notice 09-31[4] (the "Notice") provides specific guidance regarding the risks and suitability concerns associated with non-traditional ETFs and the need for a supervisory system to address those issues. The Notice stresses that firms and associated representatives must "understand the terms and features of [non-traditional ETFs], including how they are designed to perform, how they achieve that objective, and the impact that market volatility, the ETF's use of leverage, and the customer's intended holding period will have on their performance." Moreover, the Notice cautions member firms to establish a reasonable supervision system to ensure that associated persons comply with all applicable FINRA and Securities Exchange Commission ("SEC") rules when recommending any product, including non-traditional ETFs, and to implement written supervisory procedures ("WSPs") that, among other things, require that associated persons perform appropriate individualized suitability reviews.

Between August 2011 and January 2015, the representative recommended 19 LIETF purchases in 17 customer accounts. Following the representative's recommendation, his customers held these positions for periods ranging from 294 days to, in one case, almost six years. The average holding period was 722 days. These extended holding periods resulted in customer losses.

According to FINRA, the representative failed to perform a reasonable basis suitability analysis of LIETFs before offering the products to his customers. FINRA also contends that the representative failed to understand that LIETFs' generally expected to lose value over time and that losses are compounded because of how LIETFs'

[3] http://bit.ly/2oyWhiK

[4] http://bit.ly/2n2EWP6

valuations reset each day. FINRA charged the member firm with which the representative was associated with failure to maintain a supervisory system and WSPs reasonably designed to ensure that sales of LIETFs complied with applicable securities laws and regulations, National Association of Securities Dealers, Inc. and FINRA rules, or tailored to the unique features and risks of LIETFs. While the firm's WSPs described the general characteristics of LIETFs, they did not specifically address suitability, supervision or training related to the sale of LIETFs. The firm also failed to provide formal training to representatives before permitting them to sell LIETFs to retail customers. The firm did not have procedures to monitor LIETFs for potentially unsuitable holding periods. As a result, the representative did not have the proper training on LIETFs before recommending them to customers, and the firm's inadequate supervisory system allowed the representative's customers to hold LIETFs for unsuitably long periods of time.

FINRA did not allege any malicious intent on the part of the representative. The AWC simply contends that the representative was ignorant as to the key features of the products he had been selling. Representatives should ensure that they understand the products they recommend—especially complex products. Broker-dealers should also put in place the appropriate supervisory policies and training programs to ensure their representatives understand the risks and investment strategies associated with complex financial products. This is especially important for firms that operate under an independent contractor model, as was the case here.

Attorneys General Sue the SEC to Invalidate Regulation Best Interest

The Attorneys General of seven states – New York, California, Connecticut, Delaware, Maine, New Mexico, Oregon – and the District of Columbia – filed a lawsuit in the Southern District of New York (SDNY) on September 9, 2019, requesting that Regulation Best Interest be invalidated. The states argue that the SEC did not exactly follow the mandate of the Dodd-Frank Wall Street Reform and Consumer Protection Act in that Regulation Best Interest does not harmonize the standard of conduct between broker-dealers and registered investment advisers ("RIAs"). RIAs are under a fiduciary duty to act in their clients' best interest at all times, while broker-dealers, under Regulation Best Interest, are required to act in the best interest of their retail customers when recommending an investment strategy.

The states claim that Regulation Best Interest is arbitrary and capricious. It remains to be seen how the SDNY will respond, and whether the plaintiffs have standing to sue. Some commentators have questioned the purpose of the lawsuit, because if Regulation Best Interest is invalidated, broker-dealers will face continued uncertainty.

FINRA Updates Rule 2232 FAQs

FINRA recently updated its frequently asked questions about Rule 2232, which requires that FINRA members disclose in their confirms to retail customers their markups in corporate and agency debt securities if the dealer also executes one or more offsetting principal transaction on the same trading day as the customer transaction

in an aggregate trading size that meets or exceeds the customer's trade. Structured notes transactions are subject to Rule 2232.[5]

Two of the FAQs (FAQ 4.3 and 4.4) focus on the security-specific URL that must be disclosed in a confirmation for retail trades, whether or not markup disclosure is required. FINRA provided a template for the information to be included in the URL at: http://bit.ly/2ofYfEU. The required information includes, among other items, the name of the issuer, credit rating, coupon, whether the bond is callable, most recent price, yield to worst, CUSIP, TRACE symbol and bond type, as applicable. The URL also has explanations of these terms and other terms included in the URL information.

SEC Enforcement Update

On September 6, 2019, Co-Director of Enforcement Steven Peikin of the SEC delivered a speech at the Securities Conference 2019. During this address, he discussed whether the SEC's Division of Enforcement has been effective in achieving the SEC's mission.

Because retail investors are often especially vulnerable to bad actors in the securities markets, the SEC has made protecting them a top priority. One component of this effort was the formation in September 2017 of the Retail Strategy Task Focus (RSTF). The RSTF has two main objectives, both of which have a direct impact on "Main Street Investors": first, the development of data-driven analytic strategies for identifying practices in the securities markets that harm retail investors, and then generating enforcement matters in these areas; and second, to collaborate within and beyond the SEC on retail investor advocacy and outreach. The RSTF has carried out several lead-generation initiatives that led to swift enforcement actions based on the use of data analytics. The entire speech is available at http://bit.ly/2otAl90.

SEC Summarizes Regulation Best Interest and Form CRS Relationship Summary

If you were somewhat put off by the prospect of reading over 1,000 pages of adopting releases for Regulation Best Interest and the Form CRS relationship summary and amendments to Form ADV, you are now in luck. The SEC issued two Small Entity Compliance Guides, boiling down the Regulation Best Interest adopting release (770 pages) to a 14-page bullet point high-level outline and condensing the approximately 300 pages of the Form CRS adopting release to six pages. Both compliance guides nicely present the key points in a readable and understandable manner.[6]

[5] FINRA's Fixed Income Confirmation Disclosure FAQs are available at: http://bit.ly/2njOKo3

[6] The Regulation Best Interest Small Entity Compliance Guide is available at: http://bit.ly/2njwlaZ and the Form CRS Relationship Summary Small Entity Compliance Guide is available at: http://bit.ly/2nxhHgf.

FINRA: Keep Advertising Simple

In Regulatory Notice 19-31 (the "Notice"), FINRA focuses on keeping marketing materials fair and balanced, as required by FINRA Rules 2210 – 2220, but also keeping those materials short and sweet.[7] The Notice starts off by encouraging member firms to use innovative designs and techniques in their electronic advertising communications. But more importantly, FINRA focuses on encouraging members to be "precise and succinct in their explanations and disclosures." Members were encouraged to avoid including "rote or prescriptive boilerplate" that is not required by FINRA rules. Although FINRA does not object to additional disclosure, the concern is that it may inhibit or distract from an investor's understanding of the required information. For example, a generic one-page marketing piece was shown with the names of six ETFs. FINRA noted that in the small print disclaimer that took up most of the page, the only relevant part was the two sentences stating that an investor should read the prospectus before investing, as it contains relevant information, and providing a link to the prospectus. The other information on the page was considered distracting.

Draftspersons should avoid exhaustive lists of potential risks and stick to information about costs, risks or drawbacks related to what is being sold, and try to find ways to weave it into the body of the communication rather than in separate, longer disclosure (which might be ignored).

FINRA clarified that the extent of the disclosure depends on the type of communication and how it is used in the sales process. Marketing materials promoting or offering specific securities or securities services generally require disclosure, and promotional materials discussing the benefits of a particular product, type of product or service require a balanced discussion of the risks or drawbacks. This is in contrast to the following types of non-promotional communications, which require less disclosure:

- brand communications;
- educational communications;
- reference resources; and
- post-sale communications.

The Notice is a good reminder to draftspersons to avoid a kitchen sink approach to marketing materials. FINRA's view is that the important parts of the communication should not be competing against an overwhelming amount of lawyerly disclaimers unrelated to the securities or services being promoted.

[7] The Notice can be found at: http://bit.ly/2ntI9Y6.

Webinar: REVERSEinquiries Workshop Series: ETNs and Daily Redeemable Notes

Wednesday, October 16, 2019
1:00pm – 2:15pm ET
To register or for more information, please visit our event site.

During this webinar, we will discuss the securities law and exchange requirements related to issuing ETNs and daily redeemable notes. Among other things, we will discuss:

- Securities law related issues, including Regulation M considerations;
- Exchange listing process;
- Disclosure related considerations; and
- Regulatory Concerns

Mayer Brown has been named Global Law Firm of the Year (Overall) at *GlobalCapital's* 2019 Global Derivatives Awards.

Earlier this year, Mayer Brown was named Americas Law Firm of the Year (Overall) at *GlobalCapital*'s Americas Derivatives Awards.

Many thanks to *GlobalCapital* magazine for this recognition and to our clients for their trust in us and continued support.

Events

Structured Products Association Structured Products Summit

October 8, 2019
The Harvard Club of New York
35 West 44th Street
New York, NY 10036

Registration: 8:00AM – 8:30AM
Panels: 8:30AM – 5:00PM
Reception: 5:00PM – 7:00PM

Join the Structured Products Association and Mayer Brown on October 8th to hear from industry leaders on the latest developments in the structured products market and predictions for 2020 and beyond. This event will include a series of panels and opportunities to network with your peers. **This year, Rep. Jim Himes (D-CT) will be giving a keynote speech entitled "Financial Services Regulations: The Pendulum Swings Back."**

Download Program Agenda

To register, please visit our event page.

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 Q2 2019.

LinkedIn Group. Stay up to date on structured and market-linked products news by joining our 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.

The Free Writings & Perspectives, or FW&Ps, blog provides news and views on securities regulation and capital formation. The blog provides up-to-the-minute information regarding securities law developments, particularly those related to capital formation. FW&Ps also offers commentary regarding developments affecting private placements, mezzanine or "late stage" private placements, PIPE transactions, IPOs and the IPO market, new financial products and any other securities-related topics that pique our and our readers' interest. Our blog is available at: www.freewritings.law.

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