

Structured Thoughts

News for the financial services community.



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FINRA Priorities

FINRA’s annual letter to member firms regarding its 2012 regulatory and examination priorities included a number of issues relating to structured products.¹ In its letter, FINRA notes that it will focus on evidence of “yield chasing.” Also, it will consider the suitability of certain complex products (including products for which there is a limited secondary market and products for which the cash flows may be difficult to predict). Continuing the themes stated in recent Regulatory Notice 12-03, FINRA highlights a number of products as to which there are heightened concerns regarding suitability and potential misselling. These include exchange-traded products that use sophisticated trading strategies and structured products.

Know Your Distributor

Distributors are often the principal or the last point of contact with retail investors. As a result, the prevailing practice is for product manufacturers to evaluate their distributors regularly and to assess their compliance culture. Recent regulatory actions arising from the sales and supervision practices of different distributors have raised the stakes for issuers and underwriters of structured products, as the issues of reputational risk and potential litigation appear to have become more significant.

¹A full copy of the letter may be found at: <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p125492.pdf>.

There isn't necessarily a large amount of specific regulatory guidance in the U.S. as to how to conduct KYD diligence.² As a result, there are varying diligence practices relating to distributors. These practices tend to vary based upon the specific manner in which the relevant products are distributed.

Among other steps, market participants rely on distribution agreements (MSDAs) to document the product provider-distributor relationship. MSDAs generally will require that the distributor make certain representations and warranties to the issuer or to the product provider³ regarding its broker-dealer status, its compliance with applicable laws and regulations and FINRA rules (including "suitability"), and its compliance with any selling restrictions. MSDAs also typically will require that the distributor agree only to use issuer-approved offering materials, and covenant not to produce or use or disseminate other offering materials. Of course, having an MSDA in place is essential, but most product providers will want to establish screening and diligence procedures to vet new distributors, as well as procedures for periodic diligence updates.

Product producers may want to consider the following practices:

Initial screening: conducting an initial screening of a prospective distributor, which will include examining the distributor's compliance record using FINRA's BrokerCheck and other compliance databases; examining whether the distributor has been the subject of litigation claims; asking about the distributor's compliance policies and procedures, as well as its training, supervision and account monitoring practices; and asking specifically about the types of products offered by the distributor in order to assess whether the distributor is experienced in selling complex products. The product producer will want to understand the distributor's process for discharging its know-your-customer and suitability obligations.

Questionnaires: a product producer may want to use a questionnaire to request information about the broker-dealer (size, resources, business history, etc.); details regarding compliance policies; evidence that the distributor has addressed the recommendations made in FINRA's Notices to Members relating to structured products; and document the distributor's practices relating to training and investor education. The product distributor will typically maintain these questionnaires in its records.

Conferences and Visits: a product producer may consider scheduling periodic conference calls with compliance professionals at the distributor, or site visits to the distributor. The product producer can use these opportunities to have an engaged discussion addressing the relevant issues.

History with the Distributor: the product producer will want to evaluate its relationship with the distributor and consider whether the distributor has complied with the terms of the applicable MSDA, sold to retail investors that have raised suitability or other concerns, sold principally to seniors, traded in/out of structured products, etc.

Tiering of Distributors: A product producer may want to consider whether only certain distributors should be permitted to sell particular types of structured products. For example, a product producer may want to offer more conservative certificates of deposit more broadly through numerous distributors, while offering non-principal protected products with complex payoff profiles through a smaller number of distributors that have a proven compliance track record and the resources to conduct the necessary training for its registered representatives. Prior to approving a distributor to sell particular products, the product producer may want to conduct additional diligence (through a questionnaire, a conference call, a visit, etc.) to assess the distributor's qualifications in respect of more complex products.

Training and Education: A product producer should consider whether it is prepared to offer training sessions or educational materials to its distributors.

² The "Joint Associations Committee" attempted to address this regulatory gap in its May 2011 "Combined Principles for Retail Structured Products," ¶7.

³ The MSDA is typically between a distributor and the "lead underwriter" of the structured products, and frequently identifies the issuer of the product as a "third party beneficiary" of the distributor's representations and covenants.

Follow-Ups: The product producer may want to conduct special or additional inquiries with a distributor as new issues emerge—for example, a follow up to assess whether the distributor has a policy or approach for monitoring concentration, or a follow up to assess whether the distributor’s compensation practices reward its registered representatives for selling certain products over others.

On-Selling: The product producer likely will want to conduct a more thorough investigation if the distributor sells products on through other distributors. What types of procedures does the distributor itself maintain to assess its own distributors? MSDAs may also be modified to address the responsibilities of the distributor in this regard.

Best Execution

The SEC recently approved revised FINRA Rule 5310, the best execution rule, which incorporates many elements of NASD Rule 2320, with certain changes. The predecessor rule established the three quote requirement. The three quote requirement has now been replaced with Supplementary Material. This Supplementary Material provides guidance to member firms where there is limited pricing information. The rule's objective is to require a member firm to use reasonable diligence to ascertain the best market for a security and to buy or sell in such market so that the resultant price to the customer is as favorable to the customer as possible under prevailing market conditions. The three quote rule contained in the prior NASD rule was determined to be too prescriptive. The new guidance is believed to improve handling of customer orders involving securities with limited quotation or pricing information.

In conducting its diligence, a member firm has to use reasonable diligence, including, considering the character of the market for the security (price, volatility, liquidity, etc.), the size and type of the transaction, the number of markets checked, etc. In the guidance, .06 addresses Orders Involving Securities with Limited Quotations or Pricing Information, and acknowledges that markets for different securities differ. Member firms must have policies to address how the member will determine the best inter-dealer market for a security in the absence of pricing information or multiple quotations. The member can look at prior trades in the security and seek out other sources of pricing information or potential liquidity.

In the context of the comment process on this rule, SIFMA and other industry organizations had noted that the rule is not appropriate in the context of fixed income markets. FINRA noted that the rule as revised takes into account the specific facts and circumstances surrounding the market in which a security trades, whether it is an exchange, over the counter or the fixed income market.

The rule takes effect on May 31, 2012.

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