Structured Products: A Compliance Bootcamp

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Topics to be Covered

New Product Approval/Index Approval – Policies and Procedures

Index Governance and Compliance

FINRA Communications Rules

Know Your Distributor

Distributor Liability

Master Selected Dealer Agreements
New Product Approval/Index Approval – Policies and Procedures
What’s new?
New product

• What’s new?
  • No universally accepted definition of what constitutes a “new product”
  • NASD guidance: “the best practice is to err on the side of caution” and take a more inclusive view of what constitutes a “new product”

• Some examples:
  • A product or a service that the firm has never offered before
  • A new “asset class”
  • A new “reference asset”
  • A new index
  • A business in which the firm has not previously engaged
Almost new

• A material modification to an existing product may effectively render it a “new product”
  • Examples: moving from principal protected to non-principal protected; using a new underlier; introducing leverage

• Other factors to consider:
  • Offering product in a new geographic region
  • Offering product to a new class of investor (taking a previously institutional product and offering it to retail investors)
  • Offering a product in a new “wrapper” format
  • A change in fees
  • A change in distribution or sales practices
FINRA guidance

- FINRA Notice 5-26 suggests that member firms should consider the following
  - Is the product new to the marketplace or the firm?
  - Is the firm proposing to sell a product to retail investors that it has previously only sold to institutional investors?
  - Will the product be offered by representatives who have not previously sold the product?
  - Does the product require material operational or system changes?
  - Would the product involve a new or significant change in sales practice?
  - Does the product raise conflicts that have not previously been identified and addressed?
New Product Approval
New product approval

- From a regulator’s perspective, there is a presumption that a new product involves or may involve greater risk and should be subject to a special internal review and approval process
- NASD Notice to Members 05-26 highlights best practices for member firms for developing and vetting new products, which include:
  - A mandatory standardized process requiring a written new product proposal
  - An initial product review
  - A formal process to approve, disapprove or table new product proposals
  - A post-approval follow-up and review
New product approval (cont’d)

• More recently, FINRA has focused on the heightened standards applicable in the context of complex products
• FINRA Regulatory Notice 12-03, January 2012--Questions for the New Product
  • For whom is this product intended? Limited or general retail distribution, and, if limited, how will it be controlled?
  • To whom should this product not be offered?
  • What is the investment objective and is that objective reasonable in relation to the product’s characteristics? How does the product add to or improve the firm’s current offerings? Can less complex products achieve the same objectives?
  • What assumptions underlie the product, and how sound are they? How is the product expected to perform in a wide variety of market or economic scenarios? What market or performance factors determine the investor’s return? Under what scenarios would principal protection, enhanced yield, or other benefits not occur?
  • What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks?
New product approval (cont’d)

- How will the firm and registered representatives be compensated? Will the offering of the product create any conflicts of interest between the customer and any part of the firm? If so, how will those conflicts be addressed?
- Are there novel legal, tax, market, investment or credit risks?
- Does the product’s complexity impair understanding and transparency of the product?
- How does this complexity affect suitability considerations or the training requirements for the product?
- How liquid is the product?
Post-approval review

• FINRA Notice 12-03 notes that as to complex products member firms should implement a post-approval review process:
  • Firm should periodically reassess complex products a firm offers to determine whether their performance and risk profile remain consistent with the manner in which the firm is selling them.
  • Firms also should consider developing procedures to monitor how the products performed after the firm approved them.
  • Firms also should conduct periodic reviews to ensure that only associated persons who are authorized to recommend complex products to retail customers are doing so.
FINRA Report on Conflicts

• “Firms at the forefront of financial innovation are in the best position, and are uniquely obligated, to identify the conflicts of interest that may exist at a product’s inception or that develop over time.”

• Recommendations:
  • Use a product review process that includes a mandate to identify and mitigate conflicts that a product may present
  • Disclose conflicts in plain English to help ensure that customers understand
  • Product manufacturing firms can implement effective KYD policies
  • Perform post-launch reviews to identify potential problems with a product that may not have been readily apparent during the initial review—or that may have arisen as a result of economic events—and take remedial action
  • Evaluate and decline to offer products to customers when the conflicts associated with those products are too significant to be mitigated effectively
FINRA Report on Conflicts (cont’d)

• The FINRA Report highlights that new product approval may also encompass
  • reviewing and analyzing reverse inquiry trades
  • addressing distributors

• The Report also makes clear that, from FINRA’s perspective, the product manufacturer has the principal responsibility with respect to product approval/product governance
  • This is consistent with the view that has been expressed in the ISDA-SIFMA-JAC Principles
  • Also, consistent with the views expressed by European regulators in terms of allocating responsibilities between product manufacturers and product distributors
Process
Product approval process

• The legal, compliance and risk areas play a central role in new product approval
• The objective is to identify for the business the legal, regulatory, reputational, operation and other issues to be considered by the institution
• As a practical matter, the approval process also has the following objectives:
  • To alert all business partners/areas of the intention to introduce a new product,
  • To share information with all of the affected groups to ensure that there is a thorough understanding of the new product,
  • To identify all areas of concern,
  • To identify all mechanical, processing, clearing or settlement issues
  • To ensure that the new product complies with all applicable internal policies (compliance, credit, conflicts, etc.),
  • To ensure that the appropriate areas at the firm conduct product due diligence,
Product approval process (cont’d)

• As a practical matter, the approval process also has the following objectives (cont’d):
  • To have independent areas at the firm review the product,
  • To assess the target market,
  • To identify any necessary training related to the product,
  • To identify any new disclosure issues,
  • To understand and agree on the distribution channels,
  • To document the process for future review
Recent guidance

• The final IOSCO toolkit addresses “Product Approval Processes” and in that regard suggest that issuers
  • Develop appropriate systems, procedures and controls for product design,
  • Set clear roles and responsibilities for staff involved and a fitting remuneration that does not conflict with the interest of customers,
  • Consider customer interests as part of the process and not allow them to be overlooked
  • Avoid as much as possible or otherwise manage conflicts between the firm and the customer
  • Involve, as appropriate the compliance function and obtain senior management approval
  • Adopt internal policies and procedures that are reasonably designed to ensure an appropriate distributor is chosen at the product approval stage
Recent guidance (cont’d)

• The final IOSCO toolkit addresses “Post-Sales Practices” as well and suggests that these should cover:
  • Ongoing transparency/disclosure concerning the product,
  • An issuer’s internal procedures,
  • Product review,
  • Complaint handling procedures,
  • Product intervention
Guidance of the SFC

• The Hong Kong Securities and Futures Commission recently published guidance on internal product approval processes
• Helpful to review in that it is fairly comprehensive and stresses themes that have been consistent in FINRA notices to members and in European regulatory guidance
Documenting Process
Documenting the process

• Written policies or procedures requiring a “new product committee” and/or a “charter” for the new product committee
  • Composition of the committee
  • Role of the committee
  • Outline the committee’s principal objectives and necessary diligence obligations
  • Integrate reasonable basis suitability review
  • Address the basis for committee approval
    • Written business proposal
    • Support for the business proposal in the form of detailed documentation
    • An oral presentation or the opportunity for committee members to ask questions and have their questions answered and responses considered by all committee members
  • Permit approval to be made contingent on specific limitations or conditions, including, for example, to whom the product can be sold, the kind of training required, the distribution channels, the market conditions that must exist for approval to remain effective
Documenting the process (cont’d)

• Committee has to have the authority to mandate training, review disclosures
• Discuss interaction of the Committee with Risk group and with Compliance and Legal
• Formal post-approval assessment review
• Special post-approval reviews if there have been customer complaints or grievances
• Special review of any product before the Committee agrees to lift any restrictions or conditions on the sale of the product, agrees to distribute through new channels or to new geographies
Reasonable Basis
Suitability
Suitability

• Three main suitability obligations under Rule 2111:
  • “Reasonable-basis obligation” requires a member to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors.
  • “Customer-specific obligation” requires that a member have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer’s investment profile.
  • “Quantitative suitability” requires a member to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer’s profile.
• A less rigid standard applies with respect to “institutional accounts.”
Suitability (cont’d)

- In its Notices to Members, FINRA has consistently emphasized the broker-dealer’s suitability obligation—from the product design and product approval process (“new product” approval) to post-sales review
  - Notice 12-03 states that the reasonable basis suitability duty “includes reasonable diligence to understand the nature of the transaction or investment strategy” and that “reasonable diligence must provide the representative “with an understanding of the risk and rewards … [that] should be informed by an analysis of likely product performance in a wide range of normal and extreme market actions.” FINRA adds that “[t]he lack of such an understanding when making the recommendation could violate the suitability rule.”
  - The product manufacturer is best positioned to carry out the reasonable basis suitability analysis, since the manufacturer generates the product idea, designs the product features, stress tests and models the product, and is responsible for the disclosures regarding the product
Suitability (cont’d)

• Notice to Members 05-59:
  • NTM 03-07 and 03-71 state that firms have an obligation to perform a “reasonable” basis suitability determination before recommending a product to general customers.
  • Rule 2860(b)(19)(B) states that no member shall recommend a transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer has knowledge and experience in the financial matter such that the customer is capable of evaluating the risks of the transaction and is financially able to bear the risks.

• Notice 09-73: Conduct reasonable suitability assessments prior to recommending principal-protected notes to customers
  • NASD Rule 2310
  • NASD IM 2310-2(e)
Suitability (cont’d)

• FINRA Regulatory Notice 10-09: Review suitability before recommending purchase.
  • NASD Rule 2310: firms must have a reasonable basis for determining that a product is suitable for investors in general and suitable for each specific customer prior to recommending the purchase or sale of a security.

• FINRA Regulatory Notice 10-51: Conduct reasonable suitability assessments prior to recommending commodity futures-linked securities to customers.
Suitability (cont’d)

• Notice 12-03: Firm must perform a “reasonable basis” suitability determination: a transaction or investment strategy is suitable for at least some investors.
  • To do so, the firm must perform reasonable diligence to understand the nature of the transaction, as well as the potential risks and rewards.
  • This understanding should be informed by an analysis of likely product performance in a wide range of normal and extreme market actions. The lack of such an understanding when making the recommendation could violate the suitability rule.
  • Firms should have formal written procedures to ensure that their registered representatives do not recommend a complex product to a retail investor before it has been thoroughly vetted. The procedures should ensure that the right questions are answered before a complex product is recommended to retail investors.
Suitability Assessments
Suitability Assessments

• The reasonable basis suitability assessment is essential in discharging the product provider’s obligations

• Any assessment should take into account:
  • The generation of the product idea
  • The target market for the product, or the product’s intended purpose
  • The design of the product features
  • The types of conditions under which the product performance has been evaluated (looking at hypotheticals, at stress-testing, etc.)
  • The overall risks and rewards of the product
  • The financial and market risk associated with the product
  • Any legal risks
  • The complexity of the product
  • Reputational risks
Suitability Assessments (cont’d)

• In evaluating a potential new product, the Committee will want to consider whether:
  • Competitors offer similar product
  • The product pay-out is particularly complex
  • The product pay-out renders the product unsuitable for certain types of investors
  • The product incorporates leverage
  • The product references an asset class that is well understood, or an asset class that may present particular risks or may be less well understood by retail investors
  • The product references a new asset class, or a proprietary index
  • The pay-out or contingencies render the product complex
  • There are novel legal issues or novel tax issues
  • There are particular disclosure concerns
  • The format or “wrapper” in which the investment will be packaged
Suitability Assessments (cont’d)

• Some market participants categorize or “group” products based on particular attributes and may subject certain products to heightened scrutiny—for example, some market participants identify the following products as requiring closer consideration:
  • Structured products with downside risk (revcons)
  • Structured products with complex underlyings (like volatility or a proprietary index) or complex pay-outs
  • Structured products with no certainty of a coupon for the full tenor (like zero coupons, teasers, or knock-out coupons)
  • Long tenor structures (usually anything over 10 years)
  • Credit-linked products
Suitability Assessments (cont’d)

- Other market participants have formulated a “matrix” approach and identified various characteristics that a Committee should consider in connection with a suitability review. Some “benchmark” their products against other products offered by competitors.
Four Quadrants of Note and Index Complexity

- **B1**
  - Complex strategy (e.g., market-neutral, momentum, carry, negative serial correlation, etc.)
  - Frequent rebalancing
  - Multiple indexing levels
  - Actively managed
  - Broad asset class
  - High embedded leverage
  - Volatility control
  - Infrequent rebalancing
  - Direct asset exposure
  - Not actively managed
  - Specific asset or asset class
  - Low embedded leverage
  - No volatility control

- **C**
  - Downside protection (principal protection, buffer, etc.)
  - Low minimum purchase amount (<$1,000)
  - Variable or zero coupon
  - Upside limitation (e.g., return cap, return hurdle, etc.)
  - Unfavorable tax treatment

- **A**
  - Downside leverage
  - Low minimum purchase amount (>=$10,000)
  - High liquidity (e.g., listed, registered, allows for redemption, etc.)
  - Fixed coupon

- **B2**
  - Downside protection (principal protection, buffer, etc.)
  - Low minimum purchase amount (>=$10,000)
  - High liquidity (e.g., listed, registered, allows for redemption, etc.)
  - Fixed coupon

- **Index Complexity**

- **Note Complexity**
Suitability Assessments (cont’d)

• Here are some considerations that may inform the Committee’s analysis as it reviews a potential new product.
• Describe the product in general, including the maximum term to maturity.
  • Products with a longer term to maturity may be perceived as riskier, or more difficult for a potential investor to evaluate.
• Provide an example of the product under current market conditions. What assumptions underlie the product? How is the product expected to perform in different economic scenarios?
  • The Committee should consider the likely pay-out under normal scenarios, as well as under stress scenarios. FINRA will consider whether the product is “designed to fail” or whether it offers a value proposition only under certain limited scenarios.
Suitability Assessments (cont’d)

- What is the product’s investment objective? Is that investment objective reasonable in relation to the product’s characteristics? Does this product provide market access, or exposure to a particular investment strategy, or otherwise add to the firm’s current product offerings?

  - FINRA will consider the fundamental objective of the product (is it enhanced yield? Market access? etc.) Is the new product priced such that the potential yield is an appropriate rate of return in relation to the volatility of the reference asset based on comparable and similar investments, in terms of structure, volatility and risk in the market. For example, similar structured products based on reference assets that possess substantially similar volatility characteristics, but which offer materially different rates of return, should call into question whether the instrument with the lower yield meets the reasonable basis suitability standard.
Suitability Assessments (cont’d)

• How would you describe the target market for the product? Are there particular types of accounts/investors for which the product may not be appropriate?
  • Is it a retail product? High net worth/private bank client product? What are the minimum denominations? Is there a minimum purchase requirement? Is it intended for investors that seek higher yield? For investors that do not need current income?
  • Whether the economic exposure provided by the product is appropriate for the relevant class of investor, both in terms of risk and “type” of exposure.
    • For example, a product providing heavily leveraged downside exposure to a particular reference asset may not be suitable for retail investors. In addition, exposure to certain types of complex “hidden assets” (for example, “skew” and “smile”) may also not be appropriate for retail investors; even if the risk of the product is not particularly high.
    • When selling a product into the retail market, you should consider the types of investments typically held by retail investors and whether the proposed new product would be an appropriate component of such an investor’s investment mix.
Suitability Assessments (cont’d)

• whether the new product can be explained in a manner that can be reasonably expected to be understood by the relevant class of investor, and where investors in such class can be reasonably expected to be capable of evaluating the risks; and
• whether the reference asset could be sold directly to the relevant class of investor. As a general rule, if the reference asset could not be sold directly, a structured product on such reference asset should also not be sold.
Suitability Assessments (cont’d)

• Does the product incorporate leverage? Incorporate any algorithmic models, or quantitative strategies? What are the elements, if any, of the product that might be deemed “complex”? Could a less complex structured product be developed that could achieve the same objective?

  • FINRA assumes that products that incorporate leverage are “riskier” and more difficult for a retail investor to understand and evaluate. Leverage may magnify losses in unpredictable ways. Similarly, FINRA assumes that products that incorporate a proprietary model or quantitative strategies are more complex, even if the pay-out is simple. FINRA Notice 12-03 provides examples of the types of products that may be complex.

  • The Committee may consider asking additional questions or formulating an additional questionnaire for products that reference an index, which may include the following considerations: Does the index use a complex strategy (e.g., market-neutral, momentum, carry, negative serial correlation, etc.)? Does the index have high embedded leverage? Is there frequent rebalancing?
Suitability Assessments (cont’d)

• Are there multiple indexing levels? Is the index actively managed? Does the index track a broad asset class? Does the index have a volatility control? Does the note have downside leverage? Does the note have a low minimum purchase amount (<$1,000)? Does the note have an upside limitation (e.g., return cap, return hurdle, etc.)?

• What market or performance factors determine the investor’s return? Under what scenarios would principal protection, enhanced yield, contingent protection, or other presumed benefits not be realized?

• FINRA views products that incorporate “contingencies” as more challenging for retail investors to understand. Retail investors may not understand how contingencies will affect their potential investment or their return. Products with contingencies will require more detailed disclosures; disclosures must be clear. There is also a higher risk that distributors may not understand or being able to explain the contingencies.
Suitability Assessments (cont’d)

• How will the distributor be compensated for offering the product (i.e., what are the associated fees paid to third parties)? Is there anything different about the fees that will be paid in connection with the distribution of this product compared to other products?
  • FINRA is concerned that a “structured product” contains embedded fees and that the “packaging” may obscure inappropriate fees or mark-ups. In addition, FINRA is concerned that the compensation paid to product manufacturers or distributors may motivate them to sell a structured product in favor of a simpler product.

• Will the offering of the product create any conflicts of interest between the investor and any part of the firm or its affiliates? If so, how will those conflicts be addressed?
  • FINRA has conducted a “conflicts of interest” sweep and has noted that structured products may involve conflicts of interest (whether in connection with the product manufacturing by the issuer’s affiliated broker-dealer; the hedging arrangements between the affiliated broker-dealer and the issuer; the index creation; any calculation agent function; distribution through private banking or advisory channels).
Recommendations

The Committee should consider implementing a variety of tools, such as:

- Requiring higher minimum denominations
- Requiring minimum purchase requirements
- Imposing restrictions on the types of potential investors
- Limiting sales to advised channels
- Only selling the product through particular distributors that are better suited to handle complex products
- Providing additional training to the distributors
  - Requiring special training for personnel
- Granting only conditional approval for a limited period of time, subject to certain requirements
- Mandating post-approval review within a specified period of time
Index Governance and Compliance
Overview

• Structured products are often linked to proprietary or novel indices. Proprietary indices may raise issues under the Securities Act of 1933, the Investment Company Act of 1940 and the Investment Advisers Act of 1940

• General issues to consider
  • Is the index created by the issuer or an affiliate ("proprietary") or by a third party?
  • Will there be adequate disclosure about the index and its methodology?
  • Are there elements of discretion in the index, thus raising ICA or IAA issues?
  • How does the index compare against a benchmark such as the NYSE listing rules?
  • Would the Morgan Stanley test, as applied to an equity index, be satisfied?
Proprietary Indices

- Proprietary index information
  - If an affiliate of the investment bank, or a group within the investment bank, creates or maintains the index, then that index provider must be walled off from those who structure and market the product
  - Those who create and market the structured product cannot influence the index features or its components
  - NYSE Arca Equity Rule 5.2(j)(6)(C): “If the value of an Index-Linked Security listed under Rule 5.2(j)(6) is based in whole or in part on an index that is maintained by a broker-dealer, the broker-dealer shall erect a ‘firewall’ around the personnel responsible for the maintenance of such index or who have access to information concerning changes and adjustments to the index, and the index shall be calculated by a third party who is not a broker-dealer”
  - A separate group within the investment bank should be responsible for any index development
Proprietary Indices (cont’d)

• Window cleaning

  • If the index concentrates in a few equity securities, the issuer of the product and the broker-dealer should perform "window cleaning" procedures

  • Window cleaning procedures are comparable to those used when issuing a product linked to a small basket of stocks, or when linking to a non-proprietary index that has a high concentration in a particular security

  • These procedures should prevent the issuance of a product linked to a security with respect to which the broker-dealer possesses material non-public information, or as to which the broker-dealer’s research arm has a negative rating or recommendation

    – Concerns diminish somewhat when there are a large number of index constituents
Third-Party Indices

• If the index is generated by a third-party provider
  • Perform diligence on the third-party provider
    – Do they have sufficient experience?
    – Does the sponsor periodically conduct internal reviews to ensure that the index methodology is consistently and accurately applied?
  • Will the third party be the index sponsor, or play any other role?
  • Will a license be required?
  • Ensure that the index sponsor has protections in place against the misuse of material, nonpublic information
    – NYSE Arca Equity Rule 5.2(j)(6)(C): “Any advisory committee, supervisory board or similar entity that advises an index licensor or administrator or that makes decisions regarding the index or portfolio composition, methodology and related matters must implement and maintain, or be subject to, procedures designed to prevent the use and dissemination of material, non-public information regarding the applicable index or portfolio”
Disclosure Issues

• The index methodology should be publicly available
• A link to the methodology is recommended
  • A detailed methodology is essential if the index were to be transferred to another sponsor; the methodology will ensure continuity
  • Opaque methodologies with formulae:
    – Translate into plain English
    – How to summarize — risk of error
    – Include complex formulae in the offering document?
• Roles: index sponsor, calculation agent, information dissemination
  – Disclose any conflicts of interest
• Are there similar indices to compare against, with appropriate disclosure as to the differences?
• Quarterly high and low closing levels of the index and the daily closing level should be publicly available free of charge at the close of business on each trading day
NYSE Listing Rules

  • SEC has approved certain “generic” NYSE listing rules
  • Equity Index-Linked criteria for indices (summarized)
    – Minimum of ten constituents
    – Minimum market value per component of at least $75 million
    – Minimum monthly trading volume
    – No single component can be more than 25% of the dollar weight of the index, and the five highest dollar-weighted components cannot exceed 50% of the dollar weight (60% for an index of fewer than 25 components)
    – 90% of the index's weight and at least 80% of the number of components must be eligible for standardized option trading on the NYSE. Requirement doesn't apply if:
      – no underlying component represents more than 10% of the dollar weight of the index; and
      – the index has a minimum of 20 components
  – General themes
    – indices with more than 20-25 components are subject to fewer requirements
    – Avoid top-heavy indices
    – Actively traded components
Morgan Stanley No-Action Letter

- The Morgan Stanley no-action letter, which applied to a note linked to a single stock, forms a basis for analyzing equity indices. How do we get there?
  - MS allows publicly available and up-to-date disclosure on the linked stock and its issuer as substitute for detailed disclosure about the linked stock’s issuer
  - If the linked stock’s issuer has securities trading on a national exchange and that issuer is either (1) S-3 or F-3 eligible or (2) would satisfy the issuer listing requirements if it were listing debt securities, then you need not include detailed disclosure about the linked stock’s issuer in the offering document
    - As applied to indices: an equally weighted index of 20 or more constituents satisfies the Morgan Stanley test
    - What about indices that have less than 20 constituents, or indices that have 20 or more, but some have weightings of more than 5% of the index?
      - In either case, any constituent with a weighting above 5% must itself pass the Morgan Stanley test
Regulatory Hot Buttons

• FINRA Report on Conflicts of Interest
  • Focuses on potential conflicts arising when an index calculation agent is an affiliate of the issuer or the underwriter
  • Highlights that in the context of a structured product the performance of which is linked to a proprietary index (created and maintained by the product issuer) there may be hidden costs, which may be high and may be difficult for an investor to assess
Regulatory Hot Buttons (cont’d)

• European benchmark index rulemaking
  • In the aftermath of the LIBOR/EURIBOR investigations, there has been increased focus on measures that are intended to promote index transparency and restore investor confidence
  • Generally, guidance from IOSCO, ESMA and European Commission has focused on “benchmark indices”
  • Benchmark indices are understood to be more widely recognized and used indices, such as those produced by the exchanges, as well as interbank rates
  • Many of the measures under consideration take a very broad brush approach that would apply to proprietary indices as well
Regulatory Hot Buttons (cont’d)

• ESMA Principles
  • Emphasize good governance, sound methodology and transparency, in order to limit the risks of conflicts of interest and manipulation
  • Two approaches suggested: a governance-based approach and a transparency-based approach
• Governance-based approach
  • Governance mechanisms to set up and calculate indices
  • Requires an independent committee to oversee the production of indices
  • The committee would be responsible for approving the rules for the indices
• Transparency-based approach
  • Disclose to regulators and the providers’ clients the methodology for calculation of the index and the sources of data used
Regulatory Hot Buttons (cont’d)

- ESMA Principles (cont’d)
  - Information sources: the principles address sourcing of the inputs for the index (third party information versus solicited quotes, for example)
  - Past performance: the principles emphasize that retail clients should be able to access index past performance data
  - Continuity: once an index is created, there is a strong interest in continuity of the index, so this requires considering how a successor to the index provider or index calculation agent would be identified
Regulatory Hot Buttons (cont’d)

• Proposed European legislation
  • Addresses governance and controls, including by introducing
  • A code of conduct for each benchmark index
  • Conflicts of interest requirements
  • An audit requirement for the index
  • Recordkeeping requirements in order to establish an audit trail for the index
  • Notification to ESMA of the introduction of a financial instrument referencing an index
Research-based Indices

• Typical situation: the research arm of an investment bank desires to create a "best picks" index in a particular sector or sectors, reflecting a particular investment strategy or investment recommendation
  • Issue: the investment strategy underlying the index must be reduced to a detailed methodology, pursuant to which the index may be replicated by others
ICA/IAA Issues

• Tailored index
  • Proprietary “best picks” or developed by third party
  • May reflect particular research-driven views or investment recommendations

• Investment Company Act considerations
  • Is a structured product linked to a tailored index an indirect means to a managed portfolio?
  • Would SEC recharacterize structured product as an unregistered investment company?
    • Is the pool of reference assets itself a separate issuer?
      • Prudential Insurance case – separate accounts
    • Cannot do indirectly what you cannot do directly
ICA/IAA Issues (cont’d)

• Avoiding ICA issues in Delta One Instruments
  • Delta One instruments are structured products that are unsecured debt obligations of issuer the return on which is linked to a reference asset
    • Does investor’s return rely exclusively on credit of issuer, OR
    • Does return depend on investment in identifiable pool of securities?
  • Is issuer required to own reference assets in order to provide return?
  • Does issuer “control” reference assets?
  • Does investor’s return depend on issuer’s ability to manage the investment?
  • Are issuer’s investments to hedge its obligations held in general assets or segregated account?
  • Narrow-based versus broad-based index?
ICA/IAA Issues (cont’d)

• Avoiding ICA issues in Delta One Instruments
  • Does the index involve investment discretion?
    • Static baskets of equities or commodities, even if initially selected based on a particular strategy, do not present discretion issues
    • Research-driven index often involves discretion
  • Core issue: look at substance of structured product and its terms, rather than number of securities that comprise the index

• Investment Advisers Act considerations
  • Index that involves discretion raises issues under IAA
    • Does structured product resemble “investment advice”?
ICA/IAA Issues (cont’d)

• Avoiding Investment Advisers Act issues
  • Is broker-dealer sponsor of structured product acting as investment adviser?
  • Can broker-dealer rely on “broker-dealer” exemption from definition of investment adviser (Section 202(a)(11)(C) of IAA)?
    • Provides advice that is “solely incidental” to its role as a broker or dealer
    • Receives no compensation for its services
FINRA Communications Rules
What is Rule 2210, and What Does it Require?

Rule 2210 governs three categories of “communications” by FINRA member firms:

- Institutional communications;
- Retail communications; and
- Correspondence.

The rule sets forth requirements relating to approval, review and recordkeeping of communications; filing requirements and review procedures; and content standards.

Effective date: February 4, 2013. FINRA is conducting a retrospective rule review process and has solicited comments.
Communications

*Retail communication*: any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar day period.

Examples:
- Product brochures provided to retail investors;
- Any non-password protected website or communication by means of unrestricted social media;
- A communication distributed or made available by a firm consisting of a reprint of an article from an independent publication, or a report published by an independent research firm, to more than 25 retail investors within a 30 calendar day period;
- Telemarketing and other sales scripts used with more than 25 retail investors within a 30-day period.

*Correspondence*: Any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30 calendar day period.

*Institutional communication*: Any written (including electronic) communication that is distributed or made available only to institutional investors, but does not include a member’s internal communications.
Investors

Retail investor: Any person other than an institutional investor, regardless of whether the person has an account with a member.

Institutional investor: Any:

(A): • Bank, savings and loan association, insurance company or registered investment company;
   • Investment adviser registered either with the Securities and Exchange Commission (SEC) under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or
   • Other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million, regardless of whether the person has an account with a member;

(B) governmental entity or subdivision thereof;

(C) employee benefit plan, or multiple employee benefit plans offered to employees of the same employer, that meet the requirements of Section 403(b) or Section 457 of the Internal Revenue Code and in the aggregate have at least 100 participants, but does not include any participant of those plans;

(D) qualified plan, as defined in Section 3(a)(12)(C) of the Securities Exchange Act of 1934 (Exchange Act), or multiple qualified plans offered to employees of the same employer, that in the aggregate have at least 100 participants, but does not include any participant of those plans;

(E) FINRA member or registered person of that member; and

(F) person acting solely on behalf of any such institutional investor.
Institutional Communications (cont’d)

“No member may treat a communication as having been distributed to an institutional investor if the member has reason to believe that the communication or any excerpt thereof will be forwarded or made available to any retail investor.”

• A firm does not have an obligation to inquire whether an institutional communication will be forwarded to retail investors each time that that communication is distributed;

• Firms should have policies and procedures in place reasonably designed to prevent institutional communications from being forwarded to retail investors, and make appropriate efforts to implement such policies and procedures.
  o Those procedures may include the use of legends warning the recipient of an institutional communication that it is for institutional investor use only.

• To the extent that a firm becomes aware that a recipient institutional investor is forwarding or making available institutional communications to retail investors, the firm must treat future communications to the institutional investors as retail communications until it reasonably concludes that the improper practice has ceased.
Content Standards

There are general and specific content standards. The general content standards that apply to all communications are:

• All member communications must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service.
  o No member may omit any material fact or qualification if the omission, in light of the context of the material presented, would cause the communications to be misleading.
• No member may make any false, exaggerated, unwarranted, promissory or misleading statement or claim in any communication.
  o No member may publish, circulate or distribute any communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.
• Information may be placed in a legend or footnote only in the event that such placement would not inhibit an investor’s understanding of the communication.
• Members must ensure that statements are clear and not misleading within the context in which they are made, and that they provide balanced treatment of risks and potential benefits. Communications must be consistent with the risks of fluctuating prices and the uncertainty of dividends, rates of return and yield inherent to investments.
• Members must consider the nature of the audience to which the communication will be directed and must provide details and explanations appropriate to the audience.
Content Standards (cont’d)

• Communications may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast; provided, however, that this paragraph does not prohibit:
  o A hypothetical illustration of mathematical principles, provided that it does not predict or project the performance of an investment or investment strategy;
  o An investment analysis tool, or a written report produced by an investment analysis tool, that meets the requirements of FINRA Rule 2214; and
  o A price target contained in a research report on debt or equity securities, provided that the price target has a reasonable basis, the report discloses the valuation methods used to determine the price target, and the price target is accompanied by disclosure concerning the risks that may impede achievement of the price target.

• Prospectuses, preliminary prospectuses, fund profiles and similar documents that have been filed, or are exempt from filing, with the SEC are not subject to the Rule’s content standards.
Approval, Review and Recordkeeping Requirements

The Rule’s approval, review and record keeping requirements vary depending on the type of communication. Retail communications are subject to the most stringent requirements. For example, members generally must have a registered principal approve all advertisements, sales literature and independently prepared reprints prior to use.

This pre-use approval requirement does not apply to:

• institutional sales material;
• public appearances; or
• correspondence, unless it is sent to 25 or more existing retail customers within a 30 calendar day period and includes an investment recommendation or promotes a product or service of the firm.
Retail Communications – Approval and Review

- **Timing**: Retail communications must be reviewed before the earlier of this first use or its filing with the FINRA Advertising Regulation Department.

- **Who must review**: An appropriately qualified registered principal of the firm must approve each retail communication. A Series 16 Supervisory Analyst may, however, review certain retail communications.

- **Exceptions from principal pre-use approval**: The principal pre-use approval requirements do not apply to the following categories of retail communications, provided that the member firm supervises and reviews the communications in the same manner as required under NASD Rule 3010(d):
  
  - Any retail communication that is excepted from the definition of “research report” under NASD Rule 2711(a)(9)(A), unless the communication makes any financial or investment recommendation;
  
  - Any retail communication that is posted on an online interactive electronic forum; and
  
  - Any retail communication that does not make any financial or investment recommendation or otherwise promote a product or service of the member.

In addition, if (i) another member has filed the retail communication with the Department and has received a letter from the Department stating that it appears to be consistent with applicable standards; and (ii) the member using it in reliance upon the previous filing and approval has not materially altered it and will not use it in a manner that is inconsistent with the conditions of the Department’s letter, then the retail communication does not have to be pre-approved by a registered principal.
Institutional Communications – Approval and Review

The member firm must have written procedures for review of institutional communications by a principal. Those procedures must be reasonably designed to ensure that institutional communications comply with applicable standards. If the procedures do not require review of all institutional communications, they must include provision for the education and training of associated persons regarding these communications.

• FINRA has the right to request evidence that these supervisory procedures have been implemented and carried out.

Internal communications: Firms still must supervise these communications, including a firm’s internal communications that train or educate registered representatives. In this regard, a firm’s supervisory policies and procedures concerning internal training and education materials must be reasonably designed to ensure that such materials are fair, balanced and accurate.
Filing Requirements and Review Procedures

The Rule’s filing requirements depend on the type of communication and whether the firm is a new member. The type of communication will affect whether there is a “pre-use” or “concurrent with use” filing requirement.
Retail Communications – Filing Requirements – Pre-Use

Only retail communications are subject to the Rule’s filing requirements. Correspondence and institutional communications are not subject to any filing requirement with FINRA.

**Pre-Use; New Member Firms:** A new FINRA member firm must file with the Department, at least 10 business days prior to its first use, any retail communication that is published or used in any electronic or other public media, including any generally accessible website, newspaper, magazine or other periodical, radio, television, telephone or audio recording, video display, signs or billboards, motion pictures, or telephone directories (other than routine listings).

- Department approval is not required once 10 business days have passed since the filing.

“**New member firms**”: The period begins on the date when FINRA’s Central Registration Depository shows that FINRA membership has become effective and ends one year later.

**Exceptions to this pre-use filing rule for new member firms for underwriter free writing prospectuses:** Any retail communication of a new member firm that is a free writing prospectus that has been filed with the SEC under Securities Act Rule 433(d)(1)(ii) may be filed within 10 business days of first use rather than 10 business days prior to first use.
Pre-Use Filing Requirements (cont’d)

All member firms must file the following retail communications with the Department at least 10 business days prior to first use or publication and not publish or circulate them until any changes specified by the Department have been made:

• Retail communications concerning registered investment companies (including mutual funds, exchange-traded funds, variable insurance products, closed-end funds and unit investment trusts) that include or incorporate performance rankings or performance comparisons of the investment company with other investment companies when the ranking or comparison category is not generally published or is the creation, either directly or indirectly, of the investment company, its underwriter or an affiliate (together with a copy of the data on which the ranking or comparison is based);

• Retail communications concerning security futures, with the exception of (i) retail communications concerning security futures that are submitted to another self-regulatory organization having comparable standards pertaining to such retail communications; and (ii) retail communications in which the only reference to security futures is contained in a listing of the services of a member; and

• Retail communications concerning bond mutual funds that include or incorporate bond mutual fund volatility ratings.
Filing Requirements – Concurrent With Use

The following must be filed with the Department within 10 business days of first use or publication ("concurrent with use"):  
- Retail communications concerning registered investment companies other than those subject to the pre-use filing requirements;  
- Retail communications concerning public direct participation programs;  
- Any template for written reports produced by, or retail communications concerning, an investment analysis tool;  
- Any retail communication concerning collateralized mortgage obligations registered under the Securities Act;  
- Any retail communication concerning any security that is registered under the Securities Act and that is derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency ("registered structured products"), except (i) retail communications already subject to the pre-use filing requirements or (ii) the retail communications described in the four bullet points above.
  - Note that retail communications for structured products within an exemption from registration, such as Section 3(a)(2), or structured certificates of deposit, are not subject to this concurrent with use filing requirement.

Department approval is not required for concurrent with use filings.
Exemptions from the Concurrent With Use Filing Requirements

These communications are exempt from the concurrent with use filing requirements:

- Retail communications that previously have been filed with the Department and that are to be used without material change;
- Retail communications that are based on templates that were previously filed with the Department the changes to which are limited to updates of more recent statistical or other non-narrative information;
- Retail communications that do not make any financial or investment recommendation or otherwise promote a product or service of the member;
- Retail communications that do no more than identify a national securities exchange symbol of the member or identify a security for which the member is a registered market maker;
- Retail communications that do no more than identify the member or offer a specific security at a stated price;
- Prospectuses, preliminary prospectuses, fund profiles, offering circulars and similar documents that have been filed with the SEC or any state, or that are exempt from such registration, and free writing prospectuses that are exempt from filing with the SEC, except that an investment company prospectus published under Securities Act Rule 482 and a free writing prospectus that is required to be filed with the SEC under Securities Act Rule 433(d)(1)(ii) will not be considered a prospectus for purposes of this exclusion;
Exemptions from the Concurrent With Use Filing Requirements (cont’d)

- Retail communications prepared in accordance with Section 2(a)(10)(b) of the Securities Act (tombstones), or any rule thereunder, such as Rule 134, and announcements as a matter of record that a member has participated in a private placement, unless the retail communications are related to publicly offered direct participation programs or securities issued by registered investment companies;
- Press releases that are made available only to members of the media;
- Any reprint or excerpt of any article or report issued by a publisher (a “reprint”), provided that:
  - The publisher is not an affiliate of the member using the reprint or any underwriter or issuer of a security mentioned in the reprint that the member is promoting;
  - Neither the member using the reprint nor any underwriter or issuer of a security mentioned in the reprint has commissioned the reprinted article or report; and
  - The member using the reprint has not materially altered its contents except as necessary to make the reprint consistent with applicable regulatory standards or to correct factual errors;
- Correspondence;
- Institutional communications;
Exemptions from the Concurrent With Use Filing Requirements (cont’d)

• Communications that refer to types of investments solely as part of a listing of products or services offered by the member;
• Retail communications that are posted on an online interactive electronic forum; and
• Press releases issued by closed-end investment companies that are listed on the New York Stock Exchange (NYSE) under Section 202.06 of the NYSE Listed Company Manual (or any successor provision).
Specific Content Standards

**Backtested, or hypothetical historical, information:** FINRA has provided guidance on backtested data included in institutional communications relating to exchange-traded products.¹ FINRA’s approval of the use of backtested data in these materials is limited to a narrow set of circumstances. In its guidance, FINRA reiterated its historic position that the presentation of backtested data to retail investors does not comply with its disclosure standards. FINRA also warned that the backtested data should not be given excess weight in a recommendation to an investor.

In discussions with counsel, FINRA reiterated its position against the use of backtested data in retail communications relating to structured products (not just exchange-traded products). In institutional communications relating to structured products, FINRA indicated that its application of the content standards of Rule 2210(d) to backtested data would not be applicable in the same manner as to retail communications. Consequently, the use of backtested data may be appropriate in institutional communications relating to structured products, at the discretion of the broker-dealer.

¹ The FINRA guidance is available at http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P246651.
Specific Content Standards (cont’d)

All retail communications and correspondence must:

- Prominently disclose the name of the member, or the name under which the member’s broker-dealer business primarily is conducted as disclosed on the member’s Form BD, and may also include a fictional name by which the member is commonly recognized or which is required by any state or jurisdiction;
- Reflect any relationship between the member and any non-member or individual who is also named; and
- If it includes other names, reflect which products or services are being offered by the member.

Testimonials: If a testimonial in a communication concerns a technical aspect of investing, the person making the testimonial must have the knowledge and experience to form a valid opinion.

Retail communications or correspondence providing any testimonial concerning the investment advice or investment performance of a member or its products must prominently disclose the following:
Specific Content Standards (cont’d)

- The fact that the testimonial may not be representative of the experience of other customers;
- The fact that the testimonial is no guarantee of future performance or success; and
- If more than $100 in value is paid for the testimonial, the fact that it is a paid testimonial.
Specific Content Standards - Recommendations

All retail communications that include a recommendation of securities must have a reasonable basis for the recommendation.

In any communication, a member must provide, or offer to furnish upon request, available investment information supporting the recommendation. When a member recommends a corporate equity security, the member must provide the price at the time the recommendation is made.

**Required Information in a communication including a recommendation:** All retail communications that include a recommendation of securities must disclose the following conflicts of interest, to the extent applicable:

• That at the time the communication was published or distributed, the member was making a market in the security being recommended, or in the underlying security if the recommended security is an option or security future, or that the member or associated persons will sell to or buy from customers on a principal basis;

• That the member or any associated person that is directly and materially involved in the preparation of the content of the communication has a financial interest in any of the securities of the issuer whose securities are recommended, and the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position), unless the extent of the financial interest is nominal; and
Specific Content Standards - Recommendations (cont’d)

• That the member was manager or co-manager of a public offering of any securities of the issuer whose securities are recommended within the past 12 months.
Content Standards – Speaking Engagements and Public Appearances

A speaking engagement that constitutes a “public appearance” is subject to the content requirements.

Public appearance: “speaking activities that are unscripted and do not constitute retail communications, institutional communications or correspondence.”

- Public appearances are subject to the general content standards for communications (i.e., that they be fair and balanced and not include false or misleading statements).
- Scripts, slides, handouts or other written (including electronic) materials used in connection with public appearances are considered communications for purposes of the Rule.

Content requirement: For public appearances by associated persons, if an associated person recommends a security in a public appearance, the associated person must have a reasonable basis for the recommendation. The associated person also must disclose, as applicable, the following conflicts of interest:

- That the associated person has a financial interest in any of the securities of the issuer whose securities are recommended, and the nature of the financial interest, unless the extent of the financial interest is nominal; and
- Any other actual, material conflict of interest of the associated person or firm of which the associated person knows or has reason to know at the time of the public appearance.
Know-Your-Distributor
Allocation of Responsibility

• Backdrop: more complicated distribution environment.
  • Selling group members, sub-dealers, wholesalers, RIAs.

• In the U.S., there has generally not been any significant regulatory guidance that provides a perspective on the allocation of responsibilities in the structured products offering process as between the issuer and its affiliated broker-dealer (the “manufacturer”) and a distributor.

• General regulatory structure:
  • Issuer: responsibility for adequacy of disclosures.
  • Distributors: suitability/know your customer, and fair conduct of business with those customers.

• However, responsibilities of parties, and expectations of regulators, don’t necessarily fit into such neat categories.
  • Ex: 2006 Interagency Statement on Complex Structured Finance Activities – issuers expected to consider, among other things, the intended investor for an instrument.
In the context of discussing FINRA Notice 12-03 on Complex Products, FINRA representatives have characterized certain activities as “distributor” activities. Similarly, in the 2013 FINRA report on Conflicts of Interest, FINRA addresses distributor issues.

In 2008, ISDA JAC published the “Principles for Managing the Provider-Distributor Relationship” which provides a framework for considering an appropriate allocation of responsibilities. It considers these responsibilities in each phase of the offering process:

- New product approval,
- Reverse inquiry/product design,
- Training,
- Offering disclosures,
- Suitability,
- Supervisory matters, and
- Post-sale and secondary market issues.

Know-Your-Dealer (KYD)

• Until the release of FINRA’s 2013 Conflicts of Interest report, U.S. regulators did not address know-your-distributor policies in significant detail.

• An effective KYD policy is designed to help:
  • Ensure products are not being mis-sold.
  • Mitigate reputational risk if dealer does not perform in accordance with appropriate standards.
  • Reduce litigation risk for potential mis-deeds by distributors.
Practices Outlined by FINRA

- FINRA suggests these as measures that “can help mitigate the incentive to maximize product revenue through the widest possible distribution of a product.” FINRA’s suggestions include:
  - Background checks of distributors;
  - Reviewing the financial soundness of the distributor;
  - Requiring completion of a detailed questionnaire;
  - Interviewing the distributor;
  - Obtaining information about the composition and nature of the distributor’s customer base;
  - Reviewing the distributor’s compliance policies (query whether this is practicable);
  - Reviewing and approving the distributor through a committee;
  - Reviewing distributors annually; and
  - Requiring distributors to sign an agreement (MSDA).
Considerations Regarding KYD

• In formulating or reviewing a KYD policy, special attention should be given to:
  • Who reviews the background checks, questionnaires or other written materials
  • The process for addressing issues that may come to light in a questionnaire or interview
  • Who has the authority to approve a distributor
  • Whether one wants to (and/or can) review a distributor’s written supervisory procedures
  • Whether site visits are appropriate
  • Frequency of updates and approach for updates
  • Monitoring volume/type of sales made through particular distributors to identify patterns
Conflicts of Interest

• In the course of conducting KYD, it will be important to consider
  • Whether the distributor has a policy for managing conflicts of interest
  • Any embedded conflicts of interest, such as
    • If the distributor has an affiliated issuer
    • Whether the distributor has a “preferred” arrangement or a referral relationship with any issuer
    • If the issuer is a wholesaler, whether there are any conflicts of interest arising in respect of downstream dealers
  • Conflicts with advisory channels
  • Conflicts with the distributor’s own research or recommendations
  • Does the distributor have any arrangements in place that would serve to encourage a registered rep to recommend a particular product over another?
Compensation Arrangements

• Does the issuer or its affiliated broker-dealer have any special arrangements in place with the distributor?
  • Do these affect the distributor’s recommendations to clients?
  • Provide for referral or other fees?
  • Affect the price paid by the investor? Affect the economic terms of the notes?
  • Are any such arrangements required to be disclosed?
Tiering of Distributors

- Many product manufacturers group distributors in tiers or categories and approve certain distributors to sell only specific types of products. The FINRA report acknowledges the existence of this practice.

- Consideration should be given to:
  - The criteria for the tiers:
    - Based on distributor size, history, experience.
    - Based on product complexity or possibility of misselling.
  - Revisiting the tiers – not static; not set in stone.
    - Flexible to adjust to changing circumstances.
Other Considerations

• Training sessions for distributors.
• “Audits” of distributor materials, including distributor websites.
• Monitoring client complaints – BrokerCheck.
• Monitoring FINRA/SEC sweeps.
Dealer Activities and Potential Liabilities
When is a Distributor More Than a “Dealer”?  

- When does a “dealer” become a “statutory underwriter”?  
  - Section 4(a)(1) of the Securities Act exempts “transactions by any person other than an issuer, underwriter or dealer.”  
  - Section 2(a)(11) of the Securities Act: the term “underwriter” does not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors’ or sellers’ commission.  
  - Rule 141(c): an entity that manages the distribution of all or a substantial part of the issue, or that performs the functions normally performed by an underwriter or underwriting syndicate, is an underwriter within the meaning of Section 2(a)(11).  

- The determination will be highly fact specific.  
  - Is the distributor structuring the product?  
  - Is the distributor selling almost all or a majority of the tranche of the notes?  
  - How much is being sold by the issuer through its affiliated broker-dealer?  
  - Is there a special arrangement with the distributor?  

- These and other factors are likely to be considered by a court.
What if the Distributor May be a Statutory Underwriter?

• Is the distributor a party to an MSDA? or has the dealer signed on to the issuer’s MTN (or other) program?
• Does the distributor receive legal opinions, comfort letters and other deliverables?
• Does the distributor conduct any diligence on the issuer of the securities?
Master Selected Dealer Agreements
What Is a Selected Dealer Agreement?

• An agreement between an underwriter and a broker-dealer that will sell all or portion of the securities offered.
• Typically relates to multiple offerings.
• In typical parlance:
  • **Underwriter** = party that buys securities from the issuer as principal
  • **Dealer** = when an underwriter sells the securities to a registered broker-dealer, we refer to that entity as the “dealer”
Parties to the Agreement

• Only the Underwriter and the Selected Dealer

• However, the agreement may contemplate additional parties:
  • Issuer may obtain benefit of selected dealer’s representations and covenants (third party beneficiary).
  • If selected dealer is selling through other dealers, provisions may require the selected dealer to include provisions in those downstream documents for the benefit of the underwriter and potentially the issuer.

• If the Underwriter is an affiliate of the issuer, the issuer may be a party to the dealer agreement for purposes of certain representations, and possibly the indemnity provisions.
Available Forms of Agreements

- Historically, each broker-dealer had its own form or forms.
- SIFMA Form: introduced in 2009.
  - Available at: www.sifma.org/msda/
  - Has been widely used.
  - Not as useful for structured products.
- Different Forms Are Used for Securities and Non-Securities (e.g., certificates of deposit)
  - Some forms for “securities” cover both registered and non-registered offerings.
  - CDs: not subject to regulation under the 1933 Act; suite of documents is typically different.
  - Conditions for obtaining FDIC insurance (i.e., proper record keeping)
- Dealer that Sells to Other Dealers (Wholesaler) vs. Dealer that Sells to Investors
- Analogous forms exist in non-U.S. jurisdictions, such as the EU, reflecting local practices and regulatory regimes.
Common Provisions

• Specific offering/pricing terms to be set forth in separate writings and notices.
• Dealer required to deliver the red herring and other offering documents to its accounts.
• Dealer to take responsibility for suitability determinations for its account holders.
• Dealer not to provide information about the securities or the relevant issuers that is different from the information set forth in the prospectus.
• Non-registered offerings: lead underwriter to share with the dealers any relevant “blue sky” survey results.
• Dealer to comply with relevant anti-money laundering statutes and other relevant laws.
Typical dealer representations:

- No conflicts;
- Compliance with law by the dealer and its customers that are dealers;
- Dealer is registered under the Securities Exchange Act of 1934, a member in good standing of FINRA and a member of the Securities Investor Protection Corporation;
- Dealer will comply with all applicable FINRA rules in connection with the sale of the securities;
- Dealer and any customer that is a dealer has procedures in place for suitability determinations and marketing and sales of the securities;
- Compliance with anti-money laundering laws, PATRIOT Act and OFAC provisions;
- Dealer and its customers who are dealers will comply with the applicable selling restrictions, as set forth in the offering documents; and
- Dealer agrees to pay its costs in connection with its performance of its obligations under the agreement.
Common Provisions (cont’d)

Typical underwriter representations:

• Notification to dealer if underwriter becomes aware of any event that would cause the documents to contain a material misstatement or omission;
  o If the underwriter is an affiliate of the issuer, also an agreement by the issuer to correct the documents;
• No sales under the agreement if the underwriter becomes aware of a ratings downgrade of the issuer.
Typical conditions to performance by the dealer:

- No material adverse change to the financial condition of the issuer such that, in the dealer’s judgment, after consultation with the underwriter, that it is impracticable or inadvisable to proceed with the offering or delivery of the securities;
- No suspension in trading in securities generally on the NYSE, or war, such that it is impracticable or inadvisable to proceed with the offering or delivery of the securities;
- No ratings downgrade of the issuer.
Provisions Arising from FINRA Rules and Guidance

- Written agreement not to sell securities at a price that is not less than the offering price, except for FINRA members in connection with the offering. (FINRA Rule 5141.)
- Suitability determinations rest on the dealer
Frequently Negotiated Provisions/Structured Products Issues

- Does dealer have the ability to create its own offering materials? (FWPs)
  - Usually no, without underwriter’s approval.

- Dealer is familiar with relevant FINRA guidance.
  - Agreement may include a “laundry list” of the relevant regulatory notices.

- The dealer has procedures in place for compliance with:
  - FINRA Rule 2111 (Suitability);
  - FINRA Rule 2090 (Know your customer); and
  - FINRA Rule 2210 (Communications with the public).

- The dealer is familiar with:
  - NASD Notice to Members 05-59 (selling structured products);
  - NASD Notice to Members 05-26 (new product review);
  - FINRA Notice to Members 09-73 (principal protected notes);
  - FINRA Regulatory Notice 10-51 (commodity futures-linked securities); and
  - FINRA Regulatory Notice 12-03 (complex products).
Frequently Negotiated Provisions/Structured Products Issues (cont’d)

• Indemnification
  • Does a dealer that is a “wholesaler” indemnify the underwriter for acts by its distributors?
  • Dealers are increasingly asking for indemnification from issuers and underwriters in connection with structured note offerings.
    • “Dealers” shouldn’t necessarily be liable as underwriters, but there is a risk that they will be treated as such.
    • Dealers are increasingly requesting “conditions precedent” – comfort letters, legal opinions, participation in due diligence calls.
      • (Note that the three should typically be one package; i.e., the dealer should not receive an opinion without conducting its own diligence, just as an underwriter would not rely solely on an opinion without conducting its own diligence)

• Sales Permitted/Prohibited Outside the U.S.
Frequently Negotiated Provisions/Structured Products Issues (cont’d)

- SIFMA MSDA does not contain indemnification provisions.
- Some dealer agreements indemnify only for breach of the contract.
- Some dealer agreements contain full indemnification provisions for misstatements/omissions, but only to the extent that the information that caused the loss is provided by the indemnifying party.
  - Inclusion may depend on whether the dealer is allowed to create free writing prospectuses; and
  - Otherwise, very little in the prospectus about the dealer, even if they are buying the whole issuance from the underwriter.