Distribution of Structured Products and Distribution Relationships

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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.
Allocation of Responsibility (cont’d)

• 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.

• The principles are available at: http://www.sifma.org/uploadedfiles/newsroom/2008/globalrsp-distributor-principlesfinal.pdf?n=66680
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 in 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.
Common Provisions (cont’d)

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.