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Structured Thoughts

News for the financial services community.

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FINRA's 2013 Communication Rules and Revisions to MSDAs

In February 2013, FINRA's new rules relating to communications with the public became effective.[1] These new rules have affected distributors who purchase and sell structured products from one another in connection with their initial distribution. As a result, in this article, we set forth a number of potential revisions to "selected dealer agreements" and similar documents that market participants may wish to consider in light of these new rules.[2]

Addressing FINRA Filing Requirements. In some offerings of structured notes, the underwriter may furnish free writing prospectuses to distributors that are intended to be provided to the distributor's investors. Rule 2210(c)(3)(E) requires the filing with FINRA of certain free writing prospectuses relating to structured notes. Rule 2210(c)(7)(A) sets forth an exemption from filing where the relevant materials have been previously filed with FINRA.

In order to ensure that broker-dealers are aware of which materials have been filed, and which must be filed, distributors may request that underwriters advise them when a filing is necessary. A model provision could be:

> *If the [Underwriter] provides to the [Distributor] any free writing prospectus that would be required to be filed with FINRA pursuant to FINRA Rule 2210(c)(3)(E), then at the time it is so provided, [Underwriter]*

[1] For recent issues of this publication discussing the impact of these rules on structured products, please see the following links:
http://www.mofo.com/files/Uploads/Images/120621-Structured-Thoughts.pdf.
http://www.mofo.com/files/Uploads/Images/120119-Structured-Thoughts.pdf.

[2] Different forms of agreements may use different terminology to identify the parties. In this article, we refer to "underwriters" as the broker-dealers that purchase the securities from the issuer, and may on-sell them to other distributors for resale to investors (or to additional distributors). We refer to "distributors" as the broker-dealers that purchase the securities from the underwriters. We note that some of these types of agreements may be called by names other than "selected dealer agreements"; we use this phrase for convenience.

shall advise the distributor whether it has filed the free writing prospectus.[3]

If the underwriter does not intend to file these materials with FINRA (for example, because it does not intend to furnish them to retail investors), it may wish to add a provision to the effect of:

The [Distributor] acknowledges and agrees that the [Underwriter] has no intention or obligation to file any free writing prospectus under FINRA Rule 2210(c)(3), and the [Distributor] shall be responsible for any such required filing.

Content Requirements. Revised FINRA Rule 2210(d) sets forth the content requirements for retail communications. Among other things, it requires member communications to be based on principles of fair dealing and good faith, to be fair and balanced, and to provide a sound basis for evaluating the facts in regard to any particular security. Underwriters may seek representations from distributors that any materials that the distributor prepares[4] conform with these requirements. Such documents are also subject to the principal review and record retention requirements of FINRA Rule 2210(b)(1) and (b)(4). A provision could be set forth as:

Any materials prepared by the [Distributor] in accordance with this Section __ shall conform to the requirements of FINRA Rule 2210(d). [Distributor] shall be responsible for ensuring that the principal approval and record retention requirements of FINRA Rule 2210(b)(1) and (b)(4) are satisfied with respect to such materials.

Avoiding Unplanned Retail Communications. Underwriters sometimes provide materials to distributors about structured products that are not intended for distribution to investors. Such materials may include, for example, more detailed explanations of a product and its use. FINRA Rule 2210(a)(4) provides that members may not treat communications as institutional communications if they have "reason to believe" that the communication will be forwarded to retail customers.

In order to help bolster an underwriter's position that it satisfied this standard in connection with any materials, it may consider adding a provision to its agreements along the following lines:

[Distributor] shall not provide any written materials, whether in paper or electronic form (or any excerpt thereof), to any investors if the [Underwriter] has advised the [Distributor] through the use of legends, written instruction or otherwise that such materials are not intended to be so provided.

If an underwriter becomes aware that a recipient distributor is forwarding communications to retail investors, the firm must treat future communications with that distributor as retail communications until it reasonably concludes that the forwarding practice has ceased. In order to enable the underwriter to be aware of these circumstances, a provision could be set forth as follows:

If the [Distributor] or any of its employees has provided any materials of the type referred to in [the prior sentence] to any "retail investor" (as defined in FINRA Rule 2210(a)), it shall promptly cease doing so, and advise the [Underwriter] in reasonable detail of the circumstances under which such materials were provided.

Institutional Communications. Under the new rules, "institutional communications" must be subject to written procedures that address training and other issues relating to their preparation. They are also subject to record retention requirements. Accordingly, underwriters may wish to add relevant provisions to their agreements. A model provision could read:

If the [Distributor] prepares and distributes any institutional communications (as defined in FINRA Rule 2210(a)) with respect to the [Securities], it shall do so pursuant to written procedures that comply with FINRA Rule 2210(b)(3), and shall maintain such communications in accordance with FINRA Rule 2210(b)(4).

[3] Most forms of agreements contain provisions that bar the distributor from revising offering materials that have been provided by the underwriter without prior notice to, and consent from, the underwriter. If a distributor makes any revisions, the document may be subject to a separate filing requirement.
[4] See footnote 3 above.

Correspondence. The new FINRA rules define “correspondence” as any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within a 30 calendar-day period. These documents are also subject to a supervisory review process and record retention requirements. Accordingly, underwriters may wish to add relevant provisions to their agreements. A model provision could read:

> *If the [Distributor] prepares and distributes any correspondence (as defined in FINRA Rule 2210(a)) with respect to the Securities, it shall do so pursuant to written procedures that comply with FINRA Rule 3010(d), and shall maintain such communications in accordance with FINRA Rule 3010(d)(3) and FINRA Rule 4511.*

Relevant Agreement Forms. The new FINRA communication rules, other than the filing requirements, apply to structured products that are not registered securities. Accordingly, to the extent that an underwriter maintains several forms of distribution agreements, such as for structured certificates of deposit,[5] the provisions above (other than those relating to FINRA filings) may be considered for those forms as well.

Regulation R and Bank Sales of Structured Products

Federal and state banks, including those that are affiliated with issuers of structured products, remain important participants in the distribution of structured notes and structured CDs. However, banks’ distribution and brokerage activities are limited due to changes in federal law during the last several years. This article describes the provisions of Regulation R that govern these activities, as well as their impact on selected dealer agreements and similar agreements that govern these sales.

What Is Regulation R?

The SEC adopted Regulation R in 2007 in order to address some of the uncertainty surrounding bank broker-dealer activities after the 1999 passage of the Gramm-Leach-Bliley Act (the “GLB Act”). The GLB Act amended the definitions of “broker” and “dealer” under the Exchange Act by removing the global bank exception from those definitions. In the place of that exception, the GLB Act provided a list of specific, permissible bank broker-dealer activities, including networking arrangements, trust activities, custody activities and sweep accounts. If a bank’s securities activities fall within the definitions of broker or dealer, but not within one or more of the enumerated categories of permissible bank broker-dealer activities, the bank is required to transfer (*i.e.*, “push-out”) the activity to an affiliated broker-dealer.

Regulation R primarily addresses four of the statutory exceptions that preclude a bank from being deemed to be a “broker” under the Exchange Act, including two that are of principal importance to banks that participate in the structured product market: (1) networking arrangements and (2) trust and fiduciary activities.

Networking Arrangements

Section 3(a)(4)(B)(i) of the Exchange Act provides an exception from the definition of “broker” that permits a bank to contract with broker-dealers under certain conditions in order to offer bank customers securities brokerage products and services without the bank having to register as a broker-dealer (the “Networking Exception”). For example, a bank may provide office space in its branches for its affiliated broker-dealer under a networking arrangement. Regulation R defines certain of the key terms included in the Networking Exception.

1. “Nominal one-time cash fee of a fixed dollar amount”

Under the Networking Exception, there are no limitations on the types of compensation that a broker-dealer may pay a bank under a networking arrangement. However, non-licensed bank employees may only receive a “nominal one-time cash fee of a fixed dollar amount” for referring a bank customer to a broker-dealer. Under Regulation R, the phrase “nominal one-time cash fee of a fixed dollar amount” is defined as a cash payment for a referral in an amount that does

[5] Certificates of deposit are typically sold using a separate form of agreement due to, for example, (a) the different regulatory provisions that apply and (b) the need to include provisions relating to the records that are required in order to ensure that FDIC insurance will be applicable.

not exceed either:

- twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the job family that includes the relevant employee, or 1/1000th of the average of the minimum and maximum annual base salary established by the bank for the current or prior year for that job family;
- twice the employee's actual base hourly wage or 1/100th of the employee's actual annual base salary; or
- $25 dollars, periodically adjusted for inflation.

2. "Contingent on whether the referral results in a transaction"

Under the Networking Exception, a referral fee paid to an unregistered bank employee for referring a customer to a broker-dealer cannot be "contingent on whether the referral results in a transaction." Regulation R provides that a fee would be considered "contingent on whether the referral results in a transaction" if payment of the fee depends on whether (1) the referral results in a purchase or sale of a security, (2) an account is opened with a broker-dealer, (3) the referral results in a transaction involving a particular type of security, or (3) the referral results in multiple securities transactions. A referral fee may, however, be contingent on whether a customer (a) contacts or keeps an appointment with a broker-dealer as a result of the referral or (b) meets any objective, base-line qualification criteria established by the bank or broker-dealer for customer referrals, such as minimum assets, net worth, income or marginal federal or state income tax rate, or any requirement for citizenship or residency that the bank or broker-dealer may have established generally for referrals for securities brokerage accounts.

3. "Incentive compensation"

Under the Networking Exception, unregistered bank employees that refer customers to a broker-dealer cannot receive "incentive compensation" for the referral. Regulation R defines "incentive compensation" as compensation that is intended to encourage a bank employee to refer customers to a broker-dealer or give a bank employee an interest in the success of a securities transaction of a broker-dealer. Regulation R excludes from the definition of incentive compensation amounts paid by a bank under a bonus or similar plan that is paid on a discretionary basis dependent on multiple factors or variables, so long as (1) those factors or variables include multiple significant factors or variables that are not related to securities transactions of a broker-dealer, (2) a referral made by the employee is not a factor or variable in determining the employee's compensation under the plan, and (3) the employee's compensation under the plan is not determined by reference to referrals made by any other person.

In addition, Regulation R provides that the definition of incentive compensation does not prevent a bank from compensating an officer, director or employee of the bank on the basis of any measure of the overall profitability or revenue of (1) the bank, either on a stand-alone or consolidated basis, (2) any of the bank's affiliates (other than a broker-dealer) or any operating unit of the bank or an affiliate, if the affiliate or operating unit does not over time predominately engage in the business of making referrals to a broker-dealer, or (3) a broker-dealer, if the measure of overall profitability or revenue is only one of multiple factors or variables used to determine the compensation of the officer, director or employee.

Trust and Fiduciary Activities

Section 3(a)(4)(B)(ii) of the Exchange Act contains an exception from the definition of "broker" that permits a bank, under certain conditions, to effect securities transactions in a trustee or fiduciary capacity without registering as a broker-dealer (the "Trust Exception"). Under the Trust Exception, banks frequently make purchases of structured notes and structured CDs on behalf of their accountholders.

Under Regulation R, a bank must meet four general requirements in order to qualify for the Trust Exception. First, the bank must effect the transactions in either its trust department or in another department regularly examined by bank examiners for compliance with fiduciary principles and standards. Second, the bank must be "chiefly compensated" for the transactions in a manner that is consistent with fiduciary principles and standards, based on (1) an administration or annual fee, (2) a percentage of the assets under management, (3) a flat or capped per order processing fee that does not exceed the bank's cost in executing the securities transactions, or (4) any combination of these fees. Third, the bank must not publicly solicit brokerage business other than by advertising that it effects transactions in securities as part of its trust business. Fourth, the bank must comply with the "claw-back" provisions of Section 3(a)(4)(C). In other words, a bank must (a) direct the trade to a registered broker-dealer for execution, (b) effect the trade through a cross trade or substantially similar trade either within the bank or between the bank and an affiliated fiduciary that is not in violation of fiduciary principles established under applicable law, or (c) effect the trade in another manner permitted by the SEC.

The "chiefly compensated" requirement under the Trust Exception means that a bank must be compensated as a traditional trustee or fiduciary and not as a broker-dealer. Regulation R requires that the percentage of the bank's compensation as a traditional trustee or fiduciary compared to its total compensation (*i.e.*, "relationship-total compensation percentage") for each trust and fiduciary account must exceed 50%. A bank can calculate this percentage on either an account-by-account basis or a bank-wide basis, provided that it meets certain conditions under the selected approach. Regulation R also allows a bank to exclude certain types of accounts for purposes of determining its compliance under either approach.

Impact on Selected Dealer Agreements

Banks may participate in offerings of structured notes and structured CDs. However, they are regulated differently from the registered broker-dealers that are typically parties to selected dealer and similar agreements. Accordingly, a variety of differences typically exist in the agreements that underwriters may execute with them.

- The agreement may provide that the bank's purchases are limited to purchases by the bank for trust or fiduciary accounts.

- The agreement will not grant to the bank the typical selling concession.

- The bank may be requested to give a specific representation as to its compliance with the relevant provisions of the GLB Act and Regulation R. For example, a sample representation could provide: *[Distributor] represents and warrants that in connection with any offer, purchase or sale of the [Securities]: (i) it shall comply with all applicable requirements under the Graham-Leach-Bliley Act (the "GLB Act"), Regulation R under the [Exchange Act], Sections 3(a)(4) and 3(a)(5) of the [Exchange Act]; (ii) it has adopted and implemented comprehensive oversight, examination and supervision policies and procedures reasonably designed to ensure compliance with all applicable requirements under such provisions; and (iii) it shall comply with all applicable trust or fiduciary obligations and other regulations applicable to trust or fiduciary accounts.*

FCA Temporary Product Intervention Rules: Nipping It in the Bud

The Financial Conduct Authority ("FCA") has already made it clear that, in responding to threats relating to financial markets, will tolerate lower levels of risk than its predecessor, the FSA, seeking to act faster and at an earlier stage, in order to manage issues that could harm both consumers and the integrity of the market.[6]

During the course of 2011, the FSA published a discussion paper and feedback statement setting out a number of possible product interventions that may form the basis of the FCA's approach to retail financial services.[7] In December 2012, the FSA released a consultation paper (the "Consultation")[8] setting out a draft FCA Statement of Policy, further clarifying its proposed rules on product intervention. More recently, in March 2013, the FSA published a revised policy statement (the "Statement"),[9] summarising the responses received in respect of the Consultation and amending (where necessary) the December FCA Statement of Policy. This article summarises the final FCA approach formulated in the light of market input.

[6] See Chapter 3 of 'The Journey to the FCA' (October 2012) – http://www.fsa.gov.uk/pubs/other/journey-to-the-fca-standard.pdf.
[7] See Morrison & Foerster client alert, Product Intervention in the UK and the New FCA, http://www.mofo.com/files/Uploads/Images/110705-Product-Intervention-in-the-UK-and-the-New-FCA.pdf.
[8] CP12/36, FSA: http://www.fsa.gov.uk/static/pubs/cp/cp12-36.pdf.
[9] PS13/3, FSA: http://www.fca.org.uk/static/documents/consultation-papers/fsa-ps13-03.pdf.

Legal basis for the Statement

The Financial Services and Markets Act 2000 ("FSMA") (as amended by the Financial Services Act 2012) provides (at Section 138I) that the FCA should consult the new Prudential Regulation Authority ("PRA"), and thereafter the public, with respect to any permanent rules that it makes to enhance consumer protection and provide a cost/benefit analysis in respect of the proposed rules. Although launched by the FSA in August 2012, before it was disbanded, this approach can already be seen in the first product intervention consultation in relation to possible restrictions on the marketing of unregulated collective investment schemes and close substitutes to certain retail investors.[10]

However, Section 138M provides that in circumstances where it is necessary or expedient for the FCA not to comply with these requirements for the sake of consumer protection, it can create 'temporary' product intervention rules. Such rules are temporary insofar as they are not permitted to remain in existence in excess of 12 months from the date upon which they come into force. During that time, the FCA can decide whether or not to implement permanent product intervention rules. However the 12 month limit on the temporary rules cannot be extended. In accordance with Section 138N, the FCA is required to prepare and issue a statement of policy with respect to the making of temporary product intervention rules (which statement of policy has now been published in the form of the Statement).

When might product intervention rules be necessary?

The FCA provides a number of details in the Statement relating to the circumstances when it may or may not be appropriate to institute product intervention rules. The relevant factors are divided into 4 main categories of considerations:

1. *General Considerations*: These include (amongst others), whether any rules provide an appropriate means of addressing actual or potential consumer detriment, whether they are proportionate, deliverable, transparent and whether they can be supported by sufficient and appropriate evidence.

2. *Contextual Considerations*: These include (amongst others), the potential scale of the detriment in relation to the market and individual consumers, the social and market context (*e.g.*, is there potential for vulnerable groups to be affected?) and any possible unintended consequences of an intervention.

3. *Competition Considerations*: The FCA should bear in mind its objective to promote market competition. Accordingly, it should consider (amongst other things) whether the rules promote effective competition in the interest of consumers, or indeed whether they might have the reverse effect and have a negative impact on competition.

4. *Regulatory Principles*: The FCA should also have regard to its fundamental regulatory principles set out at Section 3B of FSMA. These include (amongst others) the need for it to use its resources in an efficient and economic way, the desirability of sustainable growth in the UK and the general principle that consumers should take responsibility for their own decision-making.

How will product intervention rules be made?

Initial product intervention proposals will be discussed and a paper shall be prepared by a committee at the working group level (the "Committee"). The Committee will then either propose that the temporary product intervention rules be escalated to the Board of the FCA for review, or that they should be subject to further consideration. The FCA should discuss any proposed intervention rules (temporary or otherwise) with the PRA, in order to obtain receipt of its comments before taking any action. If the FCA Board elects to publish temporary rules based upon the proposals, it will publish them on its website and take any necessary further actions. Consideration should also be made of how affected firms and consumers should be informed of any new rules.[11] The FCA is not under a duty to consult, but it should explain on its website why it has introduced any relevant new rules.

[10] The comment period for this consultation, http://www.fsa.gov.uk/static/pubs/cp/cp12-19.pdf, ended in November 2012, but the FCA has not yet published its Policy Statement and finalised rules in this respect.
[11] The FCA notes that simply publishing details of a temporary product intervention rule on its website would be insufficient. Instead, it would consider a communication strategy to be implemented which will ensure appropriate communication with both firms and consumers.

Review

During the term of a temporary product intervention rule, the FCA may feel that it is appropriate to conduct a review of its impact. This might include liaising with market participants and affected stakeholders, product providers and/or consumers to obtain their feedback. Such review might consider the effectiveness of the temporary rule, including whether its implementation has resulted in any unintended consequences, whether there have been any breaches and whether there is sufficient evidence to suggest that market participants are side-stepping the rule by implementing workarounds.

To the extent necessary, the FCA can revise a temporary product intervention rule by communicating a new statement and a rationale for the amendments. The FCA can also publish further details explaining the way that a rule is intended to work, in order to clear up any market uncertainty.

Revocation

The FCA is required to provide details of the relevant time limits that apply with respect to any temporary product intervention rules (subject to the maximum limit of 12 months). It is also able, however, to revoke temporary rules at any time. This might be because (amongst other reasons): new rules have been introduced at the EU level; it is in receipt of new evidence that the detriment which the rules were intended to alleviate no longer exists; the FCA becomes aware of certain unintended consequences of the rules; or new rules have been implemented on a permanent basis following a consultation period.

Next Steps

Appreciating that proposed regulatory reform relating to product intervention at the EU level is an ongoing process,[12] the FCA highlights in the Statement that it will continue to provide its input with respect to any such negotiations, although it will of course re-consider its statement of practice to the extent that any of the provisions prove to be incompatible with any eventual EU legislation.

In its responses to market participants, the FCA has made clear that in most situations, it expects to consult on permanent rules in order to advance its statutory objectives. The FCA does not view the employment of temporary rules as a way of replacing its existing regulatory tools. Rather, it provides a mechanism to provide protection to consumers only where prompt action is required. Further, the FCA was keen to allay market concern that the banning of market products was an inevitable outcome. It has made clear that banning products is only one possible type of product intervention and its use would only be applied in very serious cases.

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[12] As will be covered by the proposed new Markets in Financial Instruments Regulation (MiFIR) currently working its way through the EU's legislative process.

For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/Thinkingcapmkts.

Morrison & Foerster named Structured Products Firm of the Year, Americas, 2012 by *Structured Products* magazine for the fifth time in the last seven years. See the write up at http://www.mofo.com/files/Uploads/Images/120530-Americas-Awards.pdf.

Morrison & Foerster named Best Law Firm of the Americas, 2012 by *StructuredRetailProducts.com*.

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