

MARKET SOLUTIONS

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FINRA Restricts Internal Use Only Rules Through Enforcement Actions

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Over the past few years, FINRA has narrowed the gap between sales material for use with the public and internal material intended only for registered representatives. This trend continues with a series of recent enforcement actions involving Auction Rate Securities (ARS). It now appears that FINRA may be closing any remaining gap between material for the public and internal use only material.

Previous regulatory guidance on internal use only material focused primarily on two issues: first, whether the material was used only internally and not with investors; and second, whether the pieces were balanced. Now, through four enforcement settlements, which substantively dealt with the sale of ARS, FINRA is taking the position that firms violated the institutional sales literature rule, NASD Rule 2211, because their internal use only material failed to include specific cautions regarding potential risks of the type typically included in advertisements for the general public. Thus, it appears that FINRA may be of the view that at least

in certain circumstances, internal use only materials must include disclaimers equivalent to those required in marketing material distributed to public customers.

Recently, FINRA settled a number of actions through Letters of Acceptance, Waiver and Consent (AWCs), against firms that sold ARS.¹ The cases arose following the recent market freeze of liquidity

for ARS. In one of those AWCs, the firm, which was fined \$200,000, was charged with violating NASD Rules 2211 and 2110 relating to communications in its marketing and sale of ARS, as well as related supervisory violations.² FINRA found that the

firm's internal marketing materials "were not fair and balanced and did not provide a sound basis for evaluating the facts in regard to purchases of ARS" insofar as the internal marketing pieces did not disclose the risk that ARS auctions could fail and that, as a result, customers might be unable to access their funds "for substantial periods of time." FINRA found that internal sales material available to registered personnel on the

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FINRA...

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firm's internal Web Site failed to disclose these risks; FINRA chided the firm for maintaining pieces on its internal Web Site that "described ARS as 'Typically AAA rated bonds'" and for comparing the investments "as similar to seven-day variable rate put bonds," without disclosing failed auction and resulting liquidity risks.

FINRA has previously announced settlements against several other firms for similar conduct.³ In one of those actions, FINRA fined a broker-dealer acting as a "downstream" firm \$250,000 because its "internal sales material ... was not fair and balanced and did not provide a sound basis for evaluating the facts in regard to purchases of ARS."⁴ This material, available to representatives on the firm's internal Web Site, allegedly "described the auction process ... but failed to disclose that auctions could fail or the potential for illiquidity that may arise as a result of a failed auction." FINRA also criticized the comparison of ARS to money market funds because the materials "failed to disclose all material differences between these two types of investments, including the differences in liquidity and safety." FINRA charged a violation of Rule 2210 and a resulting violation of Rule 2110.

Another firm was fined \$200,000 in an AWC in which FINRA found, among other things, that an internal use only piece "did not describe adequately the potential for failed auctions, and failed to disclose the potential for illiquidity that may arise from a failed auction." As a result, FINRA charged violations of Rule 2211 and MSRB Rule G-21, and resulting violations of Rule 2110 and MSRB G-17.

Finally, FINRA imposed a \$150,000 fine against a firm for three pieces of institutional sales material described in the AWC as "informational fact sheets used to educate ... registered representatives about ARS."⁵ FINRA described the material as lacking "sufficient information to provide a sound basis for evaluating ARS" because it did not disclose the risk that ARS "could become totally illiquid in the event of subsequent failed auctions after an initial auction failure" and because the material did not "disclose that the ARS marketplace was widely subject to auction failures and liquidity problems beginning in late 2007."

FINRA charged violations of NASD Rules 2211 and 2210, and a resulting violation of Rule 2110.

In light of these settlements, firms may wish to review more carefully their internal use marketing material, including firm internal Web Sites. Firms may want to consider filing internal use only material with FINRA for review, even though such filings are not required. In addition, firms may want to watch for future developments in this area. These ARS settlements may mean that FINRA will one day require that internal use only pieces used by representatives who are trained professionals (registered with

FINRA) must contain the same risk disclosures as material used by the investing public, who are presumed to be less informed than securities professionals. FINRA may signal its thinking or changes in policy with regard to these issues in regulatory notices, new rules, or, as was the case here, through enforcement actions. ■

"From the mid-1990's to today, regulators have increasingly pressured financial institutions for in-house resources which come at the expense of the shareholders and/or customers."

¹ FINRA Announces Agreements with Three Additional Firms to Settle Auction Rate Securities Violations," available at <http://www.finra.org/Newsroom/NewsReleases/2009/P119919>; Notices, September 2009.

² See AWC No. 2008014902501.

³ "FINRA Announces Agreements with Four Additional Firms to Settle Auction Rate Securities Violations," available at <http://www.finra.org/Newsroom/NewsReleases/2009/P118646>; Notices, February 2009 at 10.

⁴ AWC No. 20080130574.

⁵ AWC No. 20080146209.

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