

# Structured Thoughts

*News for the financial services community.*



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## FINRA Issues Notice to Members re Securities Linked to Commodity Futures

As part of FINRA's continuing focus on member firms' communications with retail investors about more complex structured products and structures,<sup>1</sup> it recently released regulatory notice 10-51<sup>2</sup> reminding firms of their sales practice obligations for commodity futures-linked securities. The notice is likely to impact the sales process for a variety of commodity-linked structured products, including "principal protected" and "non-principal protected" notes, certificates of deposit, exchange-traded notes and exchange-traded funds.

Consistent with prior FINRA guidance, communications with the public about commodity futures-linked securities must be fair and balanced, and must provide a sound basis for evaluating the facts in regards to those securities. In addition, in recommending commodity futures-linked products to its customers, firms must have reasonable grounds for believing that the recommendation is suitable, and firms must train and supervise their registered representatives to ensure they understand these products.

While recognizing the growth of products designed to provide retail investors exposure to commodities and the value commodities may offer these investors, the notice concerns securities that use commodity futures contracts as their investment strategy and highlights the differences between the prices and price movements of a commodity's

<sup>1</sup> See FINRA regulatory notice 10-09 (reverse exchangeable securities); 09-73 ("principal protected" notes); 09-42 (variable life settlements); and 09-31 (leveraged and inverse exchange traded funds).

<sup>2</sup> <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122289.pdf>.

futures contracts as compared to its spot price. In doing so, FINRA notes that the security's use of commodity futures contracts, as opposed to spot prices, can lead to unexpected results for investors or registered representatives who do not understand the security or who mistakenly believe that the security will track the performance of the spot price. In addition, the notice points out that commodity futures-linked securities have varying methodologies for managing roll yield, and cautions firms that the appropriateness of the security's particular strategy will depend on the customer's situation and preferences.

The notice principally discusses issues raised in the context of securities directly linked to one or more futures contracts. However, the price differences and futures market forces outlined in the notice would appear to apply to products that track certain types of commodity indices, particularly those with strategies or methodologies that attempt to optimize roll yield. In addition, although not specifically mentioned in the notice, many of the concerns raised by FINRA would apply to commodity futures-linked certificates of deposit, even though certificates of deposit are generally not considered "securities" under federal securities laws.<sup>3</sup>

### Sales Practice Obligations

As mentioned above, firms have an obligation to ensure that their communications with the public<sup>4</sup> about commodity futures-linked securities are fair and balanced. In addition, NASD Rule 2210 requires that the communications provide customers with a sound basis for evaluating the facts regarding the securities, and the communications may not omit any material fact or qualification if omitting it would cause the communication to be misleading. Firms that sell commodity futures-linked securities may want to consider reviewing the forms of prospectuses and pricing supplements that they use, and/or augmenting their advertising materials and literature, in light of FINRA's guidance. The notice cautions against including any suggestion that a commodity futures-linked product offers a direct exposure to the commodity's spot price or any overstatement regarding the degree of correlation between the product's return and the spot price. The mere fact that the prospectus for the product indicates that the product uses futures contracts to track the price of the commodity or index, or discloses that there is a potential difference between the futures and spot prices, may not be sufficient to fulfill the firm's obligation to ensure that the information it provides is fair, balanced and not misleading.

Firms should consider including discussions of the risks associated with a product's investment strategy in using commodity futures, as well as the impact of rolling the positions held or tracked by the product and roll yield on the product's performance. Firms may also want to describe any strategies or methodologies used by the product to maximize the benefit or minimize the impact of contango or backwardation.<sup>5</sup> FINRA also warns firms not to overstate the hedging value of the commodity futures-linked product, or imply that the product's performance is always negatively correlated with equities or other assets.

In addition, under NASD Rule 2310, before recommending commodity futures-linked securities to a retail customer, the firm must have reasonable grounds for believing that the recommendation is suitable for the customer based on any facts provided by the customer about that customer's other investments and financial situation and needs. In addition, before executing the recommended transaction, the firm must make reasonable efforts to obtain information about the customer's financial status and investment objectives, as well as the customer's tax status and other information used or considered to be reasonable by the firm or the registered representative in making the recommendation. The notice references FINRA's IM-2310-2(e), which emphasizes firms' obligations for fair dealing

<sup>3</sup> See *Structured Thoughts*, October 4, 2010, for a more detailed discussion of structured certificates of deposit at <http://www.mofo.com/files/Uploads/Images/101004-Structured-Thoughts-Issue-13.pdf>.

<sup>4</sup> Under NASD Rule 2210, "communications with the public" include, among other things, advertisements, sales literature and correspondence.

<sup>5</sup> A commodity futures-linked security will typically roll its position before a contract's expiration (selling contracts with the nearest delivery dates and replacing them with contracts with more distant delivery dates). In a contango market, futures contracts that are sold have lower prices than the ones with which they are replaced, and the commodity futures-linked security would roll its position into a more expensive contract, resulting in negative roll yield. Roll yield is one of several factors that can cause the performance of a commodity futures-linked security to differ from the performance of the commodity's spot price. In contrast, in a market characterized by backwardation, futures contracts that are sold have higher prices than the ones with which they are replaced, and the commodity futures-linked security would roll its position into a less expensive contract, resulting in positive roll yield.

with customers when making recommendations or accepting orders for new financial products. With the introduction of new products, firms should make every effort to familiarize themselves with each customer's financial situation, trading experience and ability to accept the risks involved with the product. Firms should also make every effort to make customers aware of the relevant information about the product. FINRA advises that for commodity futures-linked securities, registered representatives and their retail customers discuss, among other things:

- the commodity, basket of commodities or commodity index that the product tracks;
- the product's goals, strategy and structure;
- that commodities prices, and the performance of commodity futures-linked securities, can be volatile;
- that the use of futures contracts can affect the performance of the product as compared to the performance of the underlying commodity or commodity index;
- the product's methodology, including its strategy, if any, for managing roll yield and other factors that may affect its performance; and
- the product's tax implications. (Commodity pools have different tax implications than mutual funds or exchange-traded notes.)

Firms may want to consider for which of their customers commodity futures-linked securities may be suitable before introducing these new products, or to combine the introduction of these and other new products with a review of their customers' financial situations and goals.

## Training and Supervision

Finally, the notice reminds firms that under NASD Rules 3101 and 3012, they must properly supervise their registered persons to ensure that they understand the commodity futures-linked securities they recommend and can describe them to retail investors in a manner that is fair, balanced and not misleading. FINRA requires firms to train registered persons about the characteristics, risks and goals of each product before they allow them to sell the product to its customers. The training should include instruction on how to make customers aware of the relevant information about the product as well as a presentation of factors that would make the product suitable or unsuitable for certain customers, and should not be limited only to representatives selling the products. Firms are also required to provide appropriate training to supervisors of registered persons selling commodity futures-linked products and to develop, maintain and enforce procedures and controls reasonably designed to ensure that the sales of these products will comply with federal securities laws and FINRA rules. Firms selling commodity futures-linked products may want to review their existing training materials and methods to ensure that these topics are included and should consider reviewing registered persons' correspondence and other communications with customers after the introduction of new products to ensure that they are adequately training and supervising their registered persons.<sup>6</sup>

## Other Types of Commodity-Linked Securities

By its terms, the notice does not cover certain commodity-linked instruments that are not based on futures contracts, such as securities linked to the spot price of a particular commodity. However, it is likely that many of the concepts included in notice 10-51 would apply in that context as well, such as investor suitability, training and supervision, and many of the disclosure principles. Accordingly, firms should exercise appropriate caution and implement appropriate procedures with respect to these types of instruments as well.

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<sup>6</sup> Firms that include lists of relevant FINRA notices in their compliance materials or include references to relevant FINRA notices in their broker due diligence questionnaires or selling group agreements for structured products may want to add this regulatory notice 10-51 to these types of documents.

# FINRA Issues New Guidance Regarding Content, Approval and Filing Requirements for Free Writing Prospectuses

## Summary

As part of its recent efforts to ensure greater oversight and accuracy with respect to member firms' communications with retail investors,<sup>7</sup> FINRA released Regulatory Notice 10-52 in October 2010.<sup>8</sup> The notice provides that the content standards, principal review requirements and applicable filing requirements contained in NASD Rules 2210 (Communications with the Public) and 2211 (Institutional Sales Material and Correspondence) will now apply to free writing prospectuses distributed by broker-dealers in a manner reasonably designed to lead to their broad unrestricted dissemination, as described in Rule 433 of the Securities Act. As a result, FINRA is withdrawing, in part, previous interpretive guidance from August 2006 that excluded free writing prospectuses from the requirements of Rules 2210 and 2211.<sup>9</sup>

As to structured products, the notice will most directly impact FWP's that broker-dealers broadly disseminate, such as through a public website, in order to market their offerings.

## Free Writing Prospectuses

Securities Act Rule 405 defines a free writing prospectus ("FWP") as a written communication, including an electronic communication, that constitutes an offer to sell or a solicitation to buy securities in a registered offering by means other than the statutory prospectus. An FWP may include information that is not included in the registration statement, but it may not conflict with information in the filed registration statement, including any prospectus and any Exchange Act reports incorporated by reference. Securities Act Rule 433 requires any offering participant other than the issuer to file any FWP that is distributed by or on behalf of the offering participant in a manner reasonably designed to lead to its broad unrestricted dissemination. FWP's have become an important means by which structured products are marketed and sold. They are used by a wide variety of market participants to educate investors about these products generally, as well as to offer specific securities.

## NASD Rules 2210 and 2211

NASD Rules 2210 and 2211 establish standards for the content of communications with the public by broker-dealers. The rules are designed to ensure that the communications are fair, balanced and not misleading. Rule 2210 specifically covers communications with the public, while Rule 2211 specifically covers institutional sales material and correspondence. Rule 2210(a) defines six main types of communications with the public for purposes of the rules, including advertisements, sales literature, correspondence, institutional sales material, public appearances and independently prepared reprints. "Advertisements" are defined to include any material that is published or used in any electronic or other public media; "sales literature" is defined to include any written or electronic communication that is generally distributed or made generally available to customers or the public; "independently prepared reprints" are defined to include any reprint or excerpt of any article issued by a publisher or any report concerning an investment company registered under the Investment Company Act of 1940, as amended (the "Investment Company Act"); and "institutional sales material" is defined to include any communication that is distributed or made available only to institutional investors.

<sup>7</sup> See, e.g., Regulatory Notices 10-51 (commodity futures-linked securities), 10-09 (reverse exchangeable securities/reverse convertibles); 9-73 (principal protected notes); 9-42 (variable life settlements); and 9-31 (leveraged and inverse exchange traded funds).

<sup>8</sup> See <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122310.pdf>.

<sup>9</sup> See Letter from Lisa C. Horrigan, Assistant General Counsel, NASD, to Eileen Ryan, Vice President and Associate General Counsel, Securities Industry Association, and Sarah Starkweather, Regulatory Counsel, The Bond Market Association (August 1, 2006), available at [www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P017285](http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P017285) (the "BMA Letter").

Rule 2210(b)(1) requires a registered principal<sup>10</sup> to review and approve advertisements, sales literature and independently prepared reprints before they are distributed. Rule 2210(b)(2) requires members to maintain all advertisements, sales literature and independently prepared reprints in a separate file (whether in paper or electronic format) for a period beginning on the date of first use and ending three years from the date of last use. Members must also maintain a file containing the source of any statistical table, chart, graph or other illustration used by members in communications with the public. Rule 2210(c)(2) requires member firms to file advertisements and sales literature regarding certain types of securities, including registered investment companies and public direct participation programs, with FINRA within 10 business days of first use.<sup>11</sup>

Rule 2210(d)(1) sets forth the content requirement for all communications with the public, which generally requires fair and balanced communications with no omission of any material facts or qualifications if the omission, in the light of the context of the material presented, would cause the communication to be misleading.<sup>12</sup> Rule 2210(d)(2) sets forth the content requirements for advertisements and sales literature, including prominent disclosure (1) that, if testimonials concerning investment advice or performance are provided, they may not be representative of the experience of other clients and are no guarantee of future success, (2) of material differences between any comparison in advertisements or sales literature between investments or services, and (3) of the name of the member.

Under Rule 2211(d)(1), institutional sales material also is subject to the content standards of Rule 2210(d)(1) and the applicable interpretive materials under Rule 2210. In addition, all related correspondence is subject to the content standards of Rule 2210(d)(3). The definitions of “sales literature” and “institutional sales material” do not expressly exclude issuer-created offering materials, such as FWP’s. However, as a matter of practice, FINRA does not apply any of the provisions of Rule 2210, including the content requirements, to issuer-created materials, such as prospectuses.<sup>13</sup>

### **Rationale for Withdrawing Previous Interpretive Guidance**

FINRA’s previous interpretive guidance specifically excluded from the provisions of Rules 2210 and 2211 all FWP’s, whether created by the issuer or another offering participant. However, in the recent notice, FINRA indicated that while its previous interpretive guidance was intended to promote the objectives of Rule 433, that guidance has led to inconsistent regulatory treatment of communications that present similar investor protection concerns. First, FINRA noted that there have been cases where sales material that appeared to be in material non-compliance with the content standards of Rule 2210 were excluded from the application of the rule merely because the broker-dealer asserted that the sales material constituted an FWP.<sup>14</sup> Second, FINRA noted that investment companies registered under the Investment Company Act are not eligible to use an FWP under Rule 164(f) of the Securities Act. Thus, a communication regarding an exchange traded fund (“ETF”) that is a registered investment company must comply with the content, registered principal approval and filing requirements of Rule 2210, while an FWP regarding an ETF that is not a registered investment company would be exempt from the application of the rule. Third, FINRA noted that because broker-dealers are already required to file broadly-disseminated FWP’s with the SEC, filing them with FINRA will not cause delays in the offering process.

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<sup>10</sup> Under NASD Rule 1021(a), all “principals” are required to be registered with FINRA. Under NASD Rule 1021(b), a “principal” is defined to include persons associated with a member who are actively engaged in the management of the member’s investment banking or securities business, including supervision, solicitation, conduct of business or the training of persons associated with a member for any of these functions, including, but not limited to, sole proprietors, officers, partners, managers of offices of supervisory jurisdiction and directors of corporations.

<sup>11</sup> Most materials relating to retail structured products are not covered by the filing rules. However, if the proposals described below under “Related Proposals” are enacted in their current form, that would no longer be the case.

<sup>12</sup> These standards are somewhat similar to the standards required under the federal securities laws, and enable FINRA to take action against broker-dealers that do not comply.

<sup>13</sup> See the BMA Letter.

<sup>14</sup> FINRA did not provide specific examples in the notice of the types of communications which did not comply.

## Other Issues: Broad Unrestricted Dissemination, Preliminary Prospectuses and Grandfathering

In the notice, FINRA also pointed out that the SEC has provided guidance regarding the meaning of the term “broad unrestricted dissemination” and that it would explicitly incorporate that guidance. Specifically, the SEC has noted that examples of broad unrestricted dissemination of an FWP by a broker-dealer would include posting such prospectus on an unrestricted website or releasing it to the media. Conversely, the SEC has stated that a broker-dealer would not be making a broad unrestricted dissemination if an FWP is posted to a restricted website (e.g., password protected) or sent directly to its customers, regardless of the number of customers.

FWPs prepared by issuers that are in essentially the form of, and used in lieu of preliminary prospectuses (commonly referred to as “red herrings”), would presumably continue to be subject to FINRA’s prior practice of excluding issuer-created materials, such as prospectuses, from Rules 2210 and 2211. Investors who receive these documents will continue to obtain the protections of the Securities Act as to any misleading content in these documents.

Furthermore, there will be no “grandfathering” of the new FINRA guidance. If an FWP has been posted by a broker-dealer on a public website, it should meet the content requirements and have been approved and filed (if required) in the proper manner if that has not already occurred.

### Potential Impact

In the structured products area, the notice will principally impact brochures and other sales material that broker-dealers broadly disseminate to inform investors about their offerings. In particular, materials made available on a public website will be covered. In addition to the approval and recordkeeping requirements of Rule 2210(b), the notice will provide FINRA with the ability to “police” these materials for content.

On the one hand, limiting the dissemination of materials of this kind would remove a document from the specific requirements of Rule 2210 or 2211. On the other hand, even in the absence of these FINRA provisions, these types of documents are subject to potential liability for misleading statements under the Securities Act; accordingly, underwriters and their counsel review these documents with a fair degree of caution.<sup>15</sup>

### Related Proposals

In September 2009, FINRA issued Regulatory Notice 09-55,<sup>16</sup> requesting comments on proposed new FINRA Rule 2210 governing communications with the public by FINRA member broker-dealers. The proposed rule would amend the previous NASD Rule 2210 regarding filing requirements that brokers must comply with in connection with certain retail communications. Under the proposed new FINRA Rule 2210(c)(2), a broker-dealer must file retail communications with FINRA at least 10 business days prior to first use or publication, and may not publish or circulate such materials until any changes by FINRA have been made.

Issuers of registered structured notes would be exempt from filing prospectuses under this proposed rule because those documents are filed with the SEC. However, certain documents used in the marketing of structured product offerings could be subject to the filing requirement if the rules are adopted in the originally-proposed form. Accordingly, although final rules have not been proposed, they could significantly affect the use of the offering documents covered by Notice 10-52.

<sup>15</sup> We note that in FINRA Notice 09-73 (<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120596.pdf>), FINRA commented that each item of sales material would need to be considered individually, notwithstanding the prior or subsequent delivery of a statutory prospectus. This view differs to some extent from how many view the related SEC disclosure principles, which tend to view different documents as part of a single “disclosure package.” Under the SEC’s disclosure system, items such as “Risk Factors” may, under some circumstances, be provided separately from the disclosures set forth in an FWP, as long as the risk factor disclosure is conveyed to the investor on a timely basis.

<sup>16</sup> See <http://www.finra.org/web/groups/arbitrationmediation/documents/industry/p120006.pdf>.

## Reverse Convertibles

FINRA recently announced that it had fined Ferris, Baker Watts LLC for inadequate supervision of sales of reverse convertible notes to retail customers. FINRA continues to scrutinize the appropriateness of sales of reverse convertibles to retail investors. In its statement, FINRA noted that Ferris, Baker Watts had inadequate written procedures relating to sales of these products. Broker-dealers are reminded to review their internal procedures relating to assessing suitability, as well as their procedures for assessing portfolio concentrations. Training of sales force in connection with structured product sales also should remain top of mind.

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