

Structured Thoughts

News for the financial services community.



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FINRA's Proposed Revisions to Rule 2210, Communications with the Public: Expected Impact on the Structured Products Market

Introduction

In July 2011, FINRA proposed to amend several of its rules relating to broker-dealers' communications with the public.¹ These rules relate to a number of areas, and potentially impact a wide variety of securities offerings.² In this article, we address the potential impact of these proposals on offerings of structured products, and the documents used in these transactions.

The rules were initially proposed for amendment in September 2009. FINRA's revised proposal reflects, among other things, a variety of comments that it received from industry participants. The proposals also reflect FINRA's continuing interest in offering activities relating to the structured products market.

¹ The text of the proposed rules may be found at the following web page:

<http://www.finra.org/Industry/Regulation/RuleFilings/2011/P123894>.

² For example, the proposals impact Rule 2210 (Communications with the Public), Rule 2212 (Use of Investment Companies Rankings in Retail Communications), Rule 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings), Rule 2214 (Requirements for the Use of Investment Analysis Tools), Rule 2215 (Communications with the Public Regarding Security Futures), and Rule 2216 (Communications with the Public About Collateralized Mortgage Obligations (CMOs)). We discuss a variety of these provisions in our July 26, 2011 client alert, which is available at: <http://www.mofo.com/files/Uploads/Images/110726-FINRA-Proposed-Rules-2210-2211.pdf>.

New Filing Requirements Relating to Structured Products (and Exemptions from Filing)

Filing Requirements. New Rule 2210(c)(3)(F) would require broker-dealers to file with FINRA “retail communications 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.”³

The filing would be required to be made within 10 days of the first use or publication of the relevant communication, and would be made with FINRA’s Advertising Regulation Department.⁴ The filing would not need to be made prior to the use of the document, as was contemplated by FINRA’s September 2009 rule proposal.⁵

These provisions would apply to the documentation used in a wide variety of retail structured notes. However, we would note that, based upon the text of the provision above, the filing requirement would not apply to certain types of structured products, such as:

- structured products that are bank certificates of deposit or unregistered bank notes (they are not registered under the Securities Act); and
- rate-linked products, such as step-up callable notes, which are not included in the text of the proposed rule.

The proposed filing requirement reflects FINRA’s continuing interest in the marketing materials used for structured products. The filings would provide FINRA with an enhanced opportunity to review and comment on these documents, as well as to take steps to challenge any disclosure practices of which it does not approve.

Exemption from Filing for Certain Materials. Proposed Rule 2210(c)(7)(E) would exempt from the filing requirement any prospectuses, preliminary prospectuses, offering circulars, or similar documents that have been filed with the SEC. This exemption would remove a wide variety of prospectuses and free-writing prospectuses from the filing requirements, since so many of them are in fact filed with the SEC under Rule 424(b) or Rule 433. However, this provision would not exempt from filing free-writing prospectuses that have been filed with the SEC under Securities Act Rule 433(d)(1)(ii). Rule 433(d)(1)(ii) is the provision that requires underwriters to file those free-writing prospectuses that they distribute “in a manner reasonably designed to lead to its broad unrestricted dissemination.” (Typically, this occurs by posting a document on an unrestricted website.) We refer to these types of FWP’s as “broadly disseminated underwriter FWP’s.”

This is not the first time that FINRA has focused on broadly disseminated underwriter FWP’s. In its Regulatory Notice 10-52 (October 2010),⁶ FINRA indicated that the content standards and principal review requirements of existing Rule 2110 would apply to these documents. In this notice, FINRA indicated that it had observed that a variety of these documents used by FINRA members were not in compliance with existing Rule 2110’s content standards. Accordingly, the proposed new rules continue this focus on these types of documents by seeking to ensure that they are filed with FINRA for potential review.

³ The term “retail communication” would include any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30-calendar-day period. (The “retail communication” term would replace a number of related definitions that exist in FINRA’s current rules.) The term “retail investor” would include any person other than an institutional investor (as defined under the FINRA rules), regardless of whether the person has an account with the member. (These new definitions would be set forth in Rule 2210(a).)

⁴ FINRA’s website contains instructions for effecting filings with the department:

<http://www.finra.org/web/groups/industry/@ip/@edu/documents/education/p017549.pdf>.

⁵ Such a pre-filing requirement could dramatically slow financial innovation, due to the amount of time that would pass between the time of the FINRA filing and the time at which the materials could be provided to investors. In contrast, certain different types of materials must in fact be filed prior to their first use, such as certain retail communications used by a new FINRA member during its first year of membership. (Proposed Rule 2210(c)(1)(A).)

⁶ Available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122310.pdf>. We discuss this notice in Volume 1, Issue 14 of Structured Thoughts: <http://www.mofo.com/files/Uploads/Images/101026-Structured-Thoughts.pdf>.

We note that the text of the proposed rule would remove the exemption for broadly disseminated underwriter FWP that “have been filed with the SEC under Securities Act Rule 433(d)(1)(ii).” Under a strict reading of this provision, having the issuer file such an FWP under Rule 433(d)(1)(i) (which relates to “issuer FWPs”) would appear to remove the FWP from the filing requirement.⁷ However, this reading seems to be at odds with the intent of the proposed rule, and FINRA’s interest in reviewing these documents. As a result, a variety of FWPs used and posted by underwriters on unrestricted websites would become subject to FINRA’s filing requirements. These materials include various types of product descriptions, and materials used to educate investors about structured products.

Principal Approval Requirements

Proposed FINRA Rule 2210(b)(1)(A) would require an appropriately qualified registered principal of the member to approve each retail communication before the earlier of its use or filing with FINRA. This provision is similar to the current FINRA requirements.

Adequacy of Communications

Existing Rule 2210(d)(1) requires a FINRA member’s communications to be fair, balanced, and accurate. Proposed Rule 2210(d)(1) would be supplemented to specify that:

- 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. For example, communications must be consistent with the risks of fluctuating prices and the uncertainty of dividends, rates of return, and yield. (Proposed Rule 2210(d)(1)(D).)
- FINRA 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. (Proposed Rule 2210(d)(1)(E).)

As to structured products, these provisions reflect FINRA’s continuing concern with the adequacy of risk disclosures. The proposed rule also recognizes that different investors may have different levels of understanding of different products, and that members need to tailor their retail communications in light of these factors.

Internal-Use Only Communications

Proposed supplementary material “.01” to Rule 2210 would apply certain FINRA guidance to internal-use only materials. The new material would provide that a member’s internal written communications that are intended to educate or train registered persons about the member’s products or services would be considered “institutional communications” under paragraph (a)(3) of FINRA Rule 2210. As a result, these internal communications would be subject to both the provisions of proposed FINRA Rule 2210 and NASD Rule 3010(d).⁸

Under proposed new Rule 2210(b)(3), each member must establish appropriate written procedures for the review by an appropriately qualified registered principal of these written materials. The procedures must be reasonably designed to ensure that these institutional communications comply with applicable standards. If these procedures do not require review of all institutional communications prior to their first use or distribution, they must include provisions for the education and training of a member’s personnel as to the member’s procedures governing institutional communications, documentation of that education and training, and surveillance and follow-up to ensure that the procedures are implemented and adhered to. The member must maintain evidence that these supervisory procedures have been implemented and carried out, and must make this evidence available to FINRA upon request.

⁷ And as a practical matter, most broadly disseminated underwriter FWPs used in the structured products world are filed by the issuer, since the FINRA member is usually underwriting securities of its parent corporation, which effects the FWP filing under Rule 433.

⁸ NASD Rule 3010(d) governs the supervision and review of written correspondence.

These proposals echo some of FINRA's concerns articulated in its 2011 consent agreement with UBS relating to sales of Lehman Brothers' "principal protected" structured notes.⁹ In that agreement, FINRA focused on whether UBS's internal materials were sufficient to alert members of the sales force as to the risks relating to investments in Lehman Brothers' securities. The new proposal is designed in part to help ensure that internal materials created to educate personnel as to instruments such as structured products are sufficient, balanced, and appropriate.

Spot Checking

Proposed Rule 2210(c)(6) provides that each member's written communications may be subject to a spot-check procedure, and that members must submit requested material within the time frame specified by FINRA. This provision is generally consistent with current rules, and provides a basis for FINRA to review communications and related procedures (as to both retail and institutional communications) that are governed by the rules.

Record-keeping Requirements

Proposed FINRA Rule 2210(b)(4)(A) would update FINRA's record-keeping requirements for retail and institutional communications. These requirements would be similar to FINRA's current record-keeping requirements. This provision would incorporate by reference the record-keeping format, medium, and retention period requirements of Rule 17a-4 under the Exchange Act.

The proposed rule specifies that these records would need to include, among other items:

- a copy of the communication and the dates of first and (if applicable) last use;
- the name of any registered principal who approved the communication and the date that approval was given;
- in the case of a retail communication or institutional communication that is not approved prior to first use by a registered principal, the name of the person who prepared or distributed the communication; and
- information concerning the source of any statistical table, chart, graph, or other illustration used in the communication.

Status of Proposed Rules, and Potential Impact

The SEC may approve or reject these rules 45 days after their publication in the Federal Register. The SEC may also designate a longer period for review, or initiate proceedings to determine whether the proposed rule change should be disapproved.

If the SEC approves the proposed rules, FINRA would publish a regulatory notice of the rule change within 90 days thereafter. In its proposal, FINRA states that the implementation date for the new rules would be within one year of the SEC approval. This period would enable broker-dealers to update their policies and procedures to comply with the new rules.

The proposed rules would extend FINRA's filing requirements to a significant number of documents that are used to market structured products. The filing would provide FINRA with an additional opportunity to review and comment on these documents. FINRA may use this opportunity to provide guidance to the market as to its preferred practices in the area, and/or to take disciplinary action against those issuers that do not maintain disclosures and policies that are consistent with its rules. The implementation period will provide members with an opportunity to update their practices and policies to reflect the new rules.

⁹ The agreement is available at: <http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123478.pdf>. See pages 10 and 11 of that agreement for a discussion of UBS's internal training materials.

FINRA Warns Investors About Chasing Returns in Structured Products and Other Investments

On July 25, 2011, FINRA issued an investor alert that warns investors about the risks of investing in riskier and sometimes complex products that promise higher returns. FINRA's Investor Alert, "The Grass Isn't Always Greener—Chasing Return in a Challenging Investment Environment," was prompted by significant recent inflows into investments like high-yield bond funds, floating-rate loan funds, and structured retail products.

The alert may be found at the following link:

<http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/TradingSecurities/P123947>.

The alert does not raise any significant new issues relating to the sale of structured products. However, the alert reflects FINRA's continuing concerns about how these products are marketed, and whether investors understand the nature and risks of these instruments. Regarding structured products, the release recommends that investors focus on, among other things:

- The higher risks that are associated with potentially higher returns.
- The potential lack of liquidity for structured products.
- The costs and fees associated with structured products, the impact of which on the terms of the investment may not be easy to understand.
- Whether the instrument provides the issuer with a call right that could limit the investor's returns.
- The possibility that the return on a "principal-protected" structured product may be less than that of a conventional debt security.

The alert also highlights FINRA's concerns as to leveraged ETFs, which were originally addressed in a 2009 FINRA alert.¹⁰

State of Georgia Reviewing Offerings of Reverse Convertible Notes

According to recent news reports, the Secretary of State of Georgia, who regulates securities firms, is investigating whether securities laws were violated by the sale of reverse convertible notes and similar securities to Georgia investors. According to a July 21, 2011 report in Bloomberg, the Secretary has issued subpoenas to UBS AG, Morgan Stanley, and Ameriprise Financial Inc. to determine how many reverse convertible notes each of these entities sold in Georgia and the names of the investors. According to a spokesperson for the Secretary's office, "We have multiple investigations open with regard to the sale of reverse convertible notes, and will thoroughly review all evidence to ensure that Georgia investors are protected."

With this investigation, Georgia joins a number of other states, including Texas, Massachusetts, and Alabama, that are reviewing structured product offerings.

¹⁰ See "Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors," <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/P119778>.

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Morrison & Foerster named **Structured Products Firm of the Year, Americas, 2011** by *Structured Products* magazine.

Morrison & Foerster short-listed as *Derivatives Week* magazine's 2011 Law Firm of the Year. The winner will be revealed at a ceremony on September 27, 2011.

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