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# Structured Thoughts

News for the financial services community.

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## FINRA's New Guidance Relating to Suitability – Potential Impact on Structured Products

On May 21, 2012, FINRA issued Regulatory Notice 12-25, in which FINRA provided additional guidance on its new suitability rule, FINRA Rule 2111. The notice may be found at:

http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p126431.pdf.

The additional guidance responds to industry questions about Rule 2111. Some of the additional guidance applies to sales practices in the structured products industry; we discuss that guidance below.[1] The new notice reminds the industry that many of the obligations under the new suitability rules are the same as under the predecessor rules. However, the new Q&A's provide some useful indications of FINRA's views on a variety of questions that brokers frequently must address.

[1] We previously described the provisions of FINRA Rule 2111 in Volume 1, Issue 13 of Structured Thoughts (available at: http://www.mofo.com/files/Uploads/Images/101004-Structured-Thoughts-Issue-13.pdf), as well as FINRA's announcement of the original effective date of the rule in Volume 2, Issue 1 of Structured Thoughts (available at: http://www.mofo.com/files/Uploads/Images/110120-Structured-Thoughts.pdf). We have also discussed FINRA Regulatory Notice 11-25, which contained answers to frequently asked questions about FINRA Rule 2111, in Volume 2, Issue 7 of Structured Thoughts (available at http://www.mofo.com/files/Uploads/Images/110620-Structured-Thoughts.pdf).



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**Acting in a Customer's Best Interests**

A broker's recommendation of a security must be consistent with his or her customer's best interests.[2] The suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing the broker's interests ahead of the customer's interests.[3] In answer to a question about the meaning of acting "in a customer's best interests," FINRA provided examples where brokers had violated the suitability rule by placing their interests ahead of the customer's.

One example, which would apply to structured products and any other type of security, was a broker whose motivation for recommending one product over another was to receive larger commissions.[4] FINRA noted that the cost associated with a recommendation is only one of many important factors to consider when determining whether the subject security or investment strategy involving a security or securities is suitable.[5] Steering an investor to an investment solely due to its profitability for the firm or the broker would be problematic under the suitability rules. If the recommendation is suitable for the customer and the broker is not placing the broker's interests ahead of the customer's, then the broker would not be obligated to recommend a product with the lowest commission.

When assessing whether a recommendation is in the customer's best interests, in addition to the customer's investment profile, product or strategy-related factors must also be considered. One product-related characteristic is "special or unusual features," which are present in many structured products.[6]

**Recommendations**

In answer to a request to enumerate factors to consider in determining whether a recommendation has been made for purposes of Rule 2111, FINRA pointed to existing FINRA and SEC guidance as to particular communications that could be viewed as recommendations. FINRA highlighted that "a broker-dealer's use or distribution of marketing or offering materials ordinarily would not, by itself, constitute a 'recommendation' for purposes of the suitability rule."[7] Accordingly, consistent with the understanding of practitioners, the brochures and marketing materials used by many broker-dealers relating to structured products would typically not on their own (in the absence of other communications) be deemed to be "recommendations."

**Investment Strategies**

In response to a request for a description of a suitable investment strategy, FINRA responded by explaining that a broker's recommendation that a customer generally invest in equities or fixed income securities would not be an investment strategy covered by Rule 2111, unless that recommendation was part of an asset allocation plan not eligible for the safe harbor provisions of Rule 2111.03. However, FINRA pointed out that the rule would apply to recommendations to "invest in more specific types of securities, such as high dividend companies or 'Dogs of the Dow' …."[8] The "Dogs of the Dow" strategy is premised on investing "equal dollar amounts in the ten constituents of the Dow Jones industrial average with the highest dividend yields, hold[ing] them for twelve months and then switch[ing] to a new group of dogs."[9]

As a result, a recommendation to invest in many types of structured products could trigger the requirement that the investment strategy be suitable under Rule 2111. A recommendation as to a structured product could fall into two categories of the suitability requirements – the security itself and the strategy that the security reflects.

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[2] Regulatory Notice 12-25, page 3, and footnote 15.
[3] Regulatory Notice 12-25, page 3, and footnote 16.
[4] Regulatory Notice 12-25, page 3, and footnote 17.
[5] Regulatory Notice 12-25, page 4.
[6] Regulatory Notice 12-25, page 4.
[7] Regulatory Notice 12-25, page 4 and footnote 25.
[8] Regulatory Notice 12-25, page 6.
[9] Regulatory Notice 12-25, footnote 35.



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The "investment strategy" language also covers broker's recommendations for investing in both a security and a non-security.[10] Consequently, a recommendation as to an investment strategy that involved purchases of structured certificates of deposit as part of an investment portfolio would be subject to the rule, even though structured certificates of deposit are typically not "securities."

**Risk-Based Approach to Documenting Compliance With Suitability Obligations**

In order to make an appropriate determination of suitability, a member or associated person must ascertain the customer's investment profile. Rule 2111.04 provides that a member or associated person must use reasonable diligence to obtain and analyze all of the investment profile factors included in Rule 2111(a), unless the member or associated person has a reasonable basis to believe, documented with specificity, that one or more of those factors are not relevant components of a customer's investment profile in light of the particular facts and circumstances.

FINRA provided examples of complex securities or investment strategies that would require documentation under Rule 2111.04. While large-cap, value–oriented equity securities would usually not require documentation, a complex and/or potentially risky security or investment strategy involving a security or securities usually would require documentation.[11] FINRA cited earlier Regulatory Notices and cases relating to complex and/or potentially risky securities or investment strategies involving a security or securities; those notices and cases related to, among others, commodity futures-linked securities, reverse exchangeable or reverse convertible securities, principal-protected notes, leveraged and inverse exchange-traded funds and structured products.[12]

With respect to an investment strategy involving an explicit recommendation to hold a security, firms should consider documenting recommendations to hold securities "that by their nature or due to particular circumstances could be viewed as having a shorter-term investment component; that have a periodic reset or similar mechanism that could alter a product's character over time …."[13] Examples include leveraged exchange-traded funds, due to daily reset features causing their performance over long periods to differ significantly from the performance of the underlying index or benchmark over the same period.[14] The same concern would most likely apply to exchange-traded notes with similar features.

Consequently, firms not currently doing so may wish to plan to document their recommended securities and investment strategies involving structured products.

**Reasonable-Basis Suitability**

The Rule 2111.05(a) reasonable-basis obligation contains two components, diligence on the nature of the recommended security and a determination of whether the recommendation is suitable for at least some investors. What happens if the broker does not understand the risks associated with a recommendation, even if that recommendation is suitable for some investors?

FINRA stated that "[b]rokers cannot fulfill their suitability responsibilities … when they fail to understand the securities and investment strategies they recommend."[15] Given that FINRA views most structured products as potentially complex, firms' supervisory policies and procedures must be reasonably designed to ensure that brokers understand the structured products that they recommend so that brokers can comply with their reasonable-basis obligation.

[10] Regulatory Notice 12-25, page 8.
[11] Regulatory Notice 12-25, page 9.
[12] Regulatory Notice 12-25, page 9 and footnotes 50 and 51.
[13] Regulatory Notice 12-25, page 9 and footnote 52.
[14] Regulatory Notice 12-25, page 10.
[15] Regulatory Notice 12-25, page 14.



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**Institutional Investor Exemption**

Rule 2111(b) provides an exemption from the customer-specific suitability obligation for certain institutional accounts, which focuses on two factors: "(1) whether a broker 'has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities' … and (2) whether 'the institutional customer affirmatively indicates that it is exercising independent judgment' …. A broker-dealer fulfills its customer-specific suitability obligation if all of these conditions are satisfied."[16]

FINRA noted that some institutional customers may not, in some cases, be capable of understanding a particular type of instrument or its risk. "If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product or investment strategy that is the subject of the recommendation, the scope of a broker's customer-specific obligations under the suitability rule would not be diminished by the fact that the broker was dealing with an institutional customer."[17]

Consequently, when brokers are selling structured products, which FINRA generally views as complex, to institutional customers, they should take extra care in ensuring that they are in compliance with the exception provided by Rule 2111(b).

In Regulatory Notice 12-25, FINRA confirmed that (1) it has not approved or endorsed any third-party institutional suitability certificates, (2) it has not contracted with any vendors to create such certificates on FINRA's behalf and (3) the use of such certificates does not constitute a safe harbor from Rule 2111.[18] FINRA also said that "broker-dealers are not required to use such certificates to comply with the new institutional-customer exemption."[19]

In particular, if a broker is selling structured products to institutional customers, the broker should ensure that the conditions of the Rule 2111(b) exceptions are met rather than relying solely on the customer completing an institutional suitability certificate. If a broker is relying on an oral affirmation, as opposed to a written one, it should consider having procedures in place to document the fact that it has received the affirmation.

## FINRA's Consent Agreements Target Supervisory Systems and Procedures in the Sale of Non-Traditional ETFs

**Introduction**

On May 1, 2012, the Financial Industry Regulatory Authority, Inc. ("FINRA") announced that it had fined four major investment banks for a total of more than $9.1 million dollars for the sale of leveraged and inverse exchange-traded funds ("Non-Traditional ETFs) without reasonable supervision and for not having a reasonable basis for recommending the sales.[20] Prior to the announcement, FINRA had entered into Letters of Acceptance, Waiver and

[16] Regulatory Notice 12-25, page 15.
[17] Regulatory Notice 12-25, page 16.
[18] Regulatory Notice 12-25, pages 15-16.
[19] Regulatory Notice 12-25, page 15. In Volume 3, Issue 6 of Structured Thoughts (available at http://www.mofo.com/files/Uploads/Images/120411-Structured-Thoughts.pdf), we discussed a certificate provided by SIFMA to facilitate the use of this exemption.
[20] A copy of FINRA's press release relating to these actions may be found at: http://www.finra.org/Newsroom/NewsReleases/2012/P126123.



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Consent with each of the broker-dealers that were fined (the "Consent Agreements").[21] The Consent Agreements outlined disciplinary actions which include censures, fines and restitution.

In its press release dated May 1, 2012 and the Consent Agreements, FINRA points out that leveraged and inverse ETFs often contain features such as daily reset, leveraging and compounding, which results in very different performance as compared to the performance of the related underlying indices, especially when held over longer periods. Because of these features and the complexity of these instruments, FINRA has carefully scrutinized whether FINRA members are satisfying their duties with respect to investor suitability and broker supervision. FINRA previously indicated that it was reviewing Non-Traditional ETFs, in its Regulatory Notice 09-31 (June 2009).[22]

We note that FINRA's actions in connection to these four firms focus on sales and supervision activities that occurred between January 2008 and June 2009, prior to FINRA's Regulatory Notice 09-31.

**1. A Firm Must Establish a Reasonable Supervisory System**

FINRA criticized each of the firms for failing to establish reasonable supervisory systems in connection with the sale of Non-Traditional ETFs. FINRA found that the firms' standard supervisory procedures that apply to ETFs in general were not sufficient for Non-Traditional ETFs. In order to be considered reasonable, supervisory procedures need to be tailored specifically to address the unique features and risks associated with Non-Traditional ETFs, such as the differences in performance expectations when these instruments are held over longer periods.

**2. A Firm Must Provide Adequate Training**

FINRA also criticized the firms for failing to provide adequate training for its representatives and supervisors on the features of Non-Traditional ETFs. FINRA requires that guidance and tools to educate representatives and supervisors about Non-Traditional ETFs must also be specifically tailored to the product.

**3. A Firm Must Not Make Unsuitable Recommendations**

The Consent Agreements indicated that the firms violated NASD Rule 2310, as well as NASD 2110 and FINRA Rule 2010, by recommending Non-Traditional ETFs to customers with conservative investment objectives and to customers with a primary objective of income investment. FINRA cited the firms for not performing reasonable diligence so as to understand the nature of the security recommended for purchase, as well as its risks and rewards. Furthermore, firms must understand each customer's tolerance for risk, performance expectations and intended holding periods.

**Conclusion**

The circumstances surrounding the alleged violations are particular to the facts described in the various Consent Agreements. There is, however, a common theme in many of FINRA's recent decisions with regards to establishing adequate supervisory policies and procedures specific to the behavior and risks of the structured product offered to retail customers, including Non-Traditional ETFs. Because some exchange-traded notes ("ETNs") have the same characteristics as Non-Traditional ETFs, the same concerns relating to supervision, training and investor suitability should also apply to sales of ETNs with leverage and/or inverse returns. It has been reported that FINRA is looking into ETN sales practices in the wake of the recent VelocityShares Daily 2x VIX Short Term ETN (TVIX) trading price

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[21] The Consent Agreements may be found at: http://disciplinaryactions.finra.org/viewDocument.aspx?DocNb=31714, http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=31713, http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=31712, and http://disciplinaryactions.finra.org/viewDocument.aspx?DocNb=31711.

[22] FINRA's Regulatory Notice 09-31 may be found at: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118952.pdf.



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crash. Many firms may need to carefully devise and review supervisory policies and procedures to suit different types of risks associated with various types of structured products.

# Massachusetts Fines Broker Dealer for Sales of Non-Traditional ETFs

FINRA and the SEC are not the only U.S. regulators who are paying careful attention to the structured products market. In recent years, state regulators have taken a more active role in regulating structured product sales in their respective states. Several significant ones have been conducting a review of the market, and soliciting information from issuers and broker-dealers about their activities.

At about the same time as FINRA announced the consent agreements described in the previous article, the Massachusetts Securities Division (the "Division") announced that it had entered into a consent order with a broker-dealer relating to its sales of leveraged ETFs in the state.[23] The proceeding had been initially announced in July 2011.

The Division's findings and concerns are quite similar to those discussed in the FINRA consent agreements, and the Division brought the proceeding under the authority of relevant Massachusetts laws.[24] The sales at issue took place during the period from October 2007 to December 2009. The sales and practices described in the Massachusetts consent order raise somewhat similar concerns as to suitability, supervision and training as those of the FINRA consent agreements

The consent agreement required the broker-dealer to reimburse the relevant Massachusetts investors for their losses, and to pay an administrative fine of $250,000. The market may see similar actions, as Massachusetts and other regulators continue their efforts.

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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.

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[23] The consent order may be found at the following link: http://www.sec.state.ma.us/sct/sctrbc/rbc_consent_order.pdf.
[24] In this regard, Massachusetts permits the Division to sanction broker dealers that do not comply with the FINRA rules relating to fair practices.



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