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Structured Thoughts

News for the financial services community.

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FINRA Notice Regarding Complex Products

FINRA recently released Regulatory Notice 12-03 titled "Complex Products: Heightened Supervision of Complex Products." The Notice identifies the types of products that may be considered "complex" and provides guidance to member firms regarding supervisory concerns associated with sales of complex products. Until now, in the United States we had avoided the debate ongoing for some time now in Europe regarding "complex" and non complex (simple?) products. It is interesting that FINRA is now headed in a direction similar to that taken by European regulators.

This Notice identifies as complex products those that include "complicated or intricate derivative-like features", like structured notes, certain exchange-traded funds, hedge funds and asset-backed securities. The Notice references FINRA's prior Notices to Members and Regulatory Notices regarding particular types of structured products. The Notice reminds member firms that the firms should review and assess the adequacy of their controls with respect to products that may be deemed complex. In this regard, the Notice reminds members that they must discharge their suitability obligation, which entails diligence regarding the features of the product, including potential risks and rewards. FINRA poses a number of suggested questions that should be considered during the diligence process. The Notice reminds firms that they should establish post-approval review processes in respect of new and complex products. Specialized training also may be appropriate for registered representatives charged with selling complex products. Member firms also should consider the financial sophistication of customers when recommending a complex product and should engage customers in a discussion of product features, risks, rewards and costs. Member firms also should consider whether less complex or costly products would achieve the customer's goals. In sum, many of the same themes have been communicated in prior FINRA releases; however, we note that this Notice appears to be taking the dialogue regarding financial products in a new direction on this side of the Atlantic.

FINRA's Consent Agreement: A Continued Focus on Adequate Supervisory Systems and Procedures in the Sale of Reverse Convertible Notes

Introduction

In December 2011, the Financial Industry Regulatory Authority ("FINRA") announced that it had fined Wells Fargo Investments, LLC $2 million, and required the broker-dealer to pay restitution to investors. These penalties arose from alleged unsuitable sales of reverse convertible securities by a former registered representative affiliated with the company, Alfred Chi Chen, and for failing to provide sales charge discounts on Unit Investment Trust ("UIT") transactions to eligible customers.[1]

Prior to FINRA's announcement, FINRA entered into a Letter of Acceptance, Waiver and Consent with the broker-dealer (the "Consent Agreement").[2] The Consent Agreement sets forth the factors that led to FINRA imposing these penalties.

Some of the actions described in the Consent Agreement were not unique and have been attributed to other institutions,[3] as FINRA has carefully scrutinized in recent years the appropriateness of the sale and suitability of reverse convertible notes and the adequate supervision of employees, particularly those that have offered structured products. We note that FINRA's actions focus on activities that occurred between 2006 and 2009, prior to the time that reverse convertible sales became as highly publicized as they are today, and before many institutions began to more carefully scrutinize their procedures in the area.

1. A Firm Must Establish Adequate Written Supervisory Procedures and an Effective Supervisory System for Sales of Reverse Convertibles

FINRA has emphasized the importance of adequate supervisory systems and written procedures pertaining to reverse convertible sales. One particular focus has been customer suitability. FINRA criticized the broker-dealer, through Chen, for recommending hundreds of unsuitable reverse convertible transactions to customers, most of whom were elderly,[4] and who had conservative investment objectives and limited experience investing in options and in equities.

Accordingly, close attention should be paid to customer profiles and investment history when recommending financial products such as reverse convertibles. Transactions should be approved upon adequate inquiry into the suitability of the purchases and concentrations in the accounts of these customers. FINRA suggests that firms should provide supervisors with reports that demonstrate customer investment concentrations to assist in suitability identification.

In addition, the Consent Agreement focuses on the establishment of protocols pertaining to the sales of reverse convertibles, which must be carefully monitored for compliance. During the relevant period, the broker-dealer implemented a required training program for each registered representative who sold the reverse convertibles.

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[1] A copy of FINRA's press release relating to these actions may be found at: http://www.finra.org/Newsroom/NewsReleases/2011/P125262.

[2] The Consent Agreement may be found at: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p125264.pdf.

[3] See, for example, the [April 2011] UBS consent (the "UBS Consent"), which may be found at: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123478.pdf. Our summary of the UBS Consent may be found in *Structured Thoughts*, Volume 2, Issue 4: http://www.mofo.com/files/Uploads/Images/110414-Structured-Thoughts.pdf. The Santander consent (the "Santander Consent") may be found at: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123490.pdf.

[4] According to FINRA's complaint, except for one exception, all of Mr. Chen's accounts that invested in reverse convertible notes belonged to persons who were at least 65 years old, many of whom were in their 80s and 90s.

However, as there was no system in place to ensure compliance, many registered representatives placed trades without completing the training program.

2. A Firm's Sales Representatives Must be Adequately Supervised

In the Consent Agreement, FINRA emphasized the importance of the reasonable supervision of sales representatives. FINRA criticized the broker-dealer for not investigating the suitability concerns of the reverse convertibles being sold to elderly customers. During the last two years of Chen's employment, he had derived 75% of his total commissions from reverse convertible sales, was the firm-wide top producer of reverse convertible commissions and was promoted to a senior position. To facilitate these transactions, Chen allegedly changed the investment objectives of some customers. These changes were red flags which went without investigation by his supervisors, despite compliance reports showing unreasonable concentrations of reverse convertibles in the accounts that he advised.[5]

3. A Firm Must Establish and Effect Adequate Supervisory Procedures for Sales of Unit Investment Trusts

FINRA criticized the broker-dealer for failing to apply discounts to customers who qualified for breakpoint discounts or rollover or exchange discounts, which resulted in additional sales charges to those customers. The firm had relied upon its sales force and their respective supervisors to monitor accounts for the appropriate discounts, but did not implement a formal procedure to ensure compliance.

In the Consent Agreement, FINRA emphasized the importance of establishing, maintaining and enforcing effective supervisory systems and written supervisory procedures to prevent customers from incurring unnecessary sales charges. These systems and procedures should be designed to ensure that qualified customer accounts receive their proper breakpoint discounts or rollover and exchange discounts.

Conclusion

The circumstances surrounding these alleged violations are particular to the facts described in the Consent Agreement. However, a common theme in many of FINRA's recent decisions relates to the establishment of adequate sales supervisory policies and procedures and ensuring investment suitability. The Consent Agreement demonstrates the need for firms to perform a careful review of their supervisory procedures and systems with respect to sales of structured products. We may not have seen the last of FINRA's investigation of improper sales practices.

FINRA Revises Proposal re Communications with the Public

In July 2011, FINRA proposed to amend several of its rules relating to broker-dealers' communications with the public.[6] These rules relate to a number of areas, and potentially impact a wide variety of securities offerings.[7] In December 2011, FINRA further revised its proposal.[8]

[5] FINRA's complaint against Mr. Chen (available at: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p125266.pdf) indicates a variety of unauthorized trades by Mr. Chen, including placing orders for securities for the accounts of holders who had passed away, and explicitly contravening a client's request not to make any purchases from her account.

[6] The text of the proposed rules may be found at the following web page: http://www.finra.org/Industry/Regulation/RuleFilings/2011/P123894.

[7] 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 discussed a variety of these provisions in

The December 2011 revisions remove an aspect of the July 2011 proposed rules that had generated significant controversy. Proposed supplementary material ".01" to Rule 2210, proposed in July 2011, would have applied certain FINRA guidance to internal-use only materials. The supplemental material would have provided 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 have been subject to both the provisions of proposed FINRA Rule 2210 and NASD Rule 3010(d). Among the potential effects would have been a requirement for each member to establish appropriate written procedures for review of these written materials by an appropriately qualified registered principal.

In the December 2011 revisions, FINRA has removed this supplemental material from the proposal, and has also explicitly provided that "institutional communications" do not include internal-use only materials. That being said, caution is still advisable in connection with the preparation and dissemination of internal-use only materials. Prior FINRA investigations have focused upon the adequacy of these types of materials, and whether they were sufficient to properly educate the sales force about the nature and risks of the products that they offered.

FINRA itself takes the position that these types of materials are governed by the supervisory provisions of NASD Rule 3010.

FINRA's proposal is subject to a comment period that will end on January 18, 2012.

SEC Announces Second Extension of Comment Period for Conflict of Interest Rules

In September 2011, the SEC proposed new Rule 127B, which is intended to address the conflicts of interest provisions of Section 621 of the Dodd-Frank Act. Proposed Rule 127B would generally prohibit certain persons involved in the structuring, creation and distribution of an asset-backed security ("ABS") from engaging in certain transactions that would result in a material conflict of interest with respect to any investor in that ABS. We discussed the proposal and its potential impact on structured products in a prior issue of *Structured Thoughts*, which may be accessed at the following link: http://www.mofo.com/files/Uploads/Images/111108-Structured-Thoughts.pdf.

In December 2011, the SEC announced that it would extend the comment period for the proposal until February 13, 2012. The comment period had previously been extended through January 13, 2012. The new extension will provide market participants with additional time to prepare and submit their comments on the proposal.[9] In providing the extensions, the SEC noted that the comment period for the "Volcker Rule Proposal" relating to proprietary trading and other matters will end on February 13, 2012. Accordingly, the SEC believes that the extended comment period will enable market participants to focus on, together with any other comments, the interplay between proposed Rule 127B and the Volcker Rule Proposal, and will benefit the SEC in its preparation of the final rules.

our July 26, 2011 client alert, which is available at: http://www.mofo.com/files/Uploads/Images/110726-FINRA-Proposed-Rules-2210-2211.pdf. In Volume 2, Issue 10 of *Structured Thoughts*, we addressed the potential impact of these rules on the structured products market in particular.

[8] The text of the December 2011 revisions may be found at: http://www.sec.gov/rules/sro/finra/2011/34-66049.pdf.

[9] The SEC's release concerning the extension may be found at the following link: http://www.sec.gov/rules/proposed/2011/34-66058.pdf.

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

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