FINRA’s Enhanced Focus on Suitability

1.5 CLE Credits

December 11, 2013, 8:30AM – 10:00AM

Speakers: Lloyd Harmetz
        Daniel Nathan

1. Presentation
2. Structured Thoughts: Volume 4, Issue 14
3. Article: FINRA gives member firms a thumbs up on suitability rule compliance
Focus on Suitability

December 11, 2013
Lloyd S. Harmetz
Daniel A. Nathan
Overview
Critiques of “Complex” Products

- Regulators and the popular press have become increasingly skeptical about financial products that are viewed as the result of “financial engineering” or significant “structuring”

- A number of concerns are raised repeatedly, including the following:
  - Do investors understand the products?
  - Are these products suitable for retail investors?
  - Do these products serve a function, or simply “repackage” otherwise available assets at a cost?
  - Are there embedded costs that are not well understood by investors?
  - Are there conflicts of interest inherent in the structuring and sales process?
  - Can a broker explain these products in simple terms?
Regulatory Guidance/Cases

- NASD on Selling Non-Conventional Investments (3-71, Nov. 2003)
- NASD on New Products (5-26, April 2005)
- NASD on Structured Products (5-59, Sept. 2005)
- FINRA on Leveraged and Inverse ETFs (9-31, June 2009)
- FINRA on PPNs (9-73, Dec. 2009)
- FINRA on RevCons (10-09, Feb. 2010)
- FINRA on Commodity Futures-Linked Securities (10-51, Oct. 2010)
- FINRA sweep on RevCons (March 2011)
- FINRA actions (HR Block, Ferris Baker, Santander, UBS Financial Services)
- SEC/FINRA Investor Education Release (July 2011)
Regulatory Guidance/Cases (cont’d)

- FINRA Communications Release (July 2011, finalized in 2012)
- SEC OCIE Sweep (July 2011)
- Lehman decision (Southern District of NY)
- New Hampshire and other states
- SR – FINRA 2010-39 – Changes to the Know Your Customer Rule (Rule 2090) and the Suitability (Rule 2111)
- FINRA on Complex Products (12-03, Jan. 2012)
- SEC “sweep” letter (April 2012)
Focus on Suitability
New Rule 2111

- Revised suitability standards became effective in October 2011
- FINRA Rule 2111: A member must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer in response to the member’s reasonable efforts to obtain information concerning the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the member considers to be reasonable in making recommendations
New Rule 2111 (cont’d)

• A significantly less rigid standard applies with respect to “institutional accounts”
  • A member or associated person fulfills the customer-specific suitability obligation for an institutional account if:
    • (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, and
    • (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations.
  • The Rule does not require a broker-dealer to have a hard copy agreement on file showing that an institutional customer intends to exercise independent judgment; a firm can take a risk-based approach to documenting it.
• Standards likely to change in connection with Dodd-Frank and related efforts by the SEC and FINRA
New Rule 2111 (cont’d)

• There are three main suitability obligations under Rule 2111:
  • “Reasonable-basis obligation” requires a member to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors.
  • “Customer-specific obligation” requires that a member have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer’s investment profile.
  • “Quantitative suitability” requires a member to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer’s profile.
New Rule 2111 (cont’d)

• “Investment strategy involving a security or securities” – also covered by the rule
  • “Strategy” is interpreted broadly
  • Includes an explicit recommendation to hold a security or securities
Broker Dealer Obligations

• In its Notices to Members, FINRA has consistently emphasized the broker-dealer’s suitability obligation—from the product design and product approval process (“new product” approval) to post-sales review
  • Notice 12-03 states that the reasonable basis suitability duty “includes reasonable diligence to understand the nature of the transaction or investment strategy” and that “reasonable diligence must provide the representative “with an understanding of the risk and rewards … [that] should be informed by an analysis of likely product performance in a wide range of normal and extreme market actions.” FINRA adds that “[t]he lack of such an understanding when making the recommendation could violate the suitability rule”
  • The product manufacturer is best positioned to carry out the reasonable basis suitability analysis, since the manufacturer generates the product idea, designs the product features, stress tests and models the product, and is responsible for the disclosures regarding the product
Questions FINRA Has Asked in Reviewing Suitability Policies

• What employee training has the firm implemented regarding changes to the suitability rule?

• Does the firm offer training for associated persons to address investment strategies and hold recommendations?

• How does the firm define investment strategies, including hold recommendations, and how are these topics supervised?

• Describe the firm’s supervisory and compliance procedures for reasonable-basis, customer-specific and quantitative suitability, such as:
  • Addressing accounts with incomplete information
  • Supervising accounts with concentrations in investments and strategies that don’t match the customer’s investment profile
  • Supervising “hold recommendations”
Questions FINRA Has Asked in Reviewing Suitability Policies (cont’d)

• What tools (e.g., exception reports) does the firm use to identify in-and-out trading and high turnover rates and commission-equity ratios?

• Institutional accounts:
  • How does the firm determine whether customers meet the definition of “institutional account” and are capable of evaluating investment risks independently?
  • How does the firm obtain an affirmative acknowledgement that an institutional customer is exercising independent judgment in evaluating a recommendation?

• Portfolio Analytic Tools and Models:
  • How does the firm determine whether the tools or models make recommendations subject to the suitability rule or meet the criteria for the safe harbor in Rule 2111.03?
  • Who develops these tools?
  • Who uses these tools (clients, representatives or both)?
  • How does the firm periodically review and test the effectiveness of the tools?
  • If the tools or models make recommendations subject to the suitability rule, how are those recommendations supervised?
• Notice provides FINRA’s observations from its recent examinations
• Discusses practices which it deemed effective
• “Adopting practices discussed in this Notice will not ensure rule compliance or result in a safe harbor, but we believe they are positive steps in building a strong compliance environment”
• Observations of effective practices categorized according to:
  • Reasonable basis suitability
  • Customer specific suitability
  • Quantitative suitability
• Reasonable-Basis Suitability:
  • Established investment committees to vet complex products under the reasonable-basis suitability standard
  • Internal posting of due diligence of products, which may be used by representatives to recommend products
  • Training for representatives before they may engage in the sale of an approved product, including testing
  • Update representatives as to any new information relating to the product
• Customer-Specific Suitability
  • Firms made necessary technological changes and process changes to capture the additional customer profile data required under the new rules.
  • Flagging accounts that did not have full information, and potentially avoided recommended transactions with those investors.
  • More granular analysis of investor characteristics and risk tolerance; flagging vulnerable investors.
  • Targeted discussions with vulnerable customers, including more frequent portfolio assessments.

• Quantitative Suitability
  • Most firms monitor customer accounts for churning and excessive trading.
  • Updating surveillance and monitoring by incorporating aspects of the rule changes, such as additional customer profile information, into data and exception reports.
  • FINRA believes that firms should evaluate whether their compensation arrangements could incentivize a sales person to engage in excessive trading, or to make unsuitable recommendations.
Deficiencies that FINRA identified:

- Inadequate procedures for “hold” recommendations
- How does the firm supervise them and document them?
- Recommendations:
  - Hold ticket or hold blotter
  - Notes of discussions
Complex Products
FINRA Regulatory Notice 12-03, January 2012

• Heightened supervision of complex products
  • Guidance to firms about supervision
  • An attempt to identify characteristics that render a product “complex” – largely focused on structured products

• Complex Products Defined -- “Any product with multiple features that affect its investment returns differently under various scenarios is potentially complex. This is particularly true if it would be unreasonable to expect an average retail investor to discern the existence of these features and to understand the basic manner in which these features interact to produce an investment return”
Examples of Complex Products

• Products that include an embedded derivative component “that may be difficult to understand”:
  • Reference asset, the performance of which is not readily available to investors. (e.g., the CMS rate)
  • Notes that provide for different stated returns throughout the lifetime of the product. (e.g., steepener notes with a high teaser rate)
  • Range accrual notes
  • Notes where loss is possible, but no participation in gains (RevCons)
  • Notes with a “knock in” or “knock out” feature, where a change in the performance of the reference asset can have a disproportionate impact on the repayment of capital or on the payment of return
  • Products with contingencies in gains or losses, particularly those that depend upon multiple mechanisms, such a range accrual note with two or more reference assets
Examples of Complex Products (cont’d)

- Notes with “worst-of” features
- Investments tied to the performance of markets that may not be well understood by many investors, such as volatility
- Products with principal protection that is conditional or partial, or that can be withdrawn under certain circumstances
- Product structures that can lead to performance that is significantly different from what an investor may expect, such as products with leveraged returns that are reset daily (e.g., leveraged ETFs)
- Products with complicated limits or formulas for the calculation of investor gains
FINRA Regulatory Notice 12-03, January 2012
Approval Requirements for Complex Products

- Firm must perform a “reasonable basis” suitability determination: a transaction or investment strategy is suitable for at least some investors
- To do so, the firm must perform reasonable diligence to understand the nature of the transaction, as well as the potential risks and rewards
- This understanding should be informed by an analysis of likely product performance in a wide range of normal and extreme market actions. The lack of such an understanding when making the recommendation could violate the suitability rule
- Firms should have formal written procedures to ensure that their registered representatives do not recommend a complex product to a retail investor before it has been thoroughly vetted. The procedures should ensure that the right questions are answered before a complex product is recommended to retail investors
Questions for the New Product

• For whom is this product intended? Limited or general retail distribution, and, if limited, how will it be controlled?
• To whom should this product not be offered?
• What is the investment objective and is that objective reasonable in relation to the product’s characteristics? How does the product add to or improve the firm’s current offerings? Can less complex products achieve the same objectives?
• What assumptions underlie the product, and how sound are they? How is the product expected to perform in a wide variety of market or economic scenarios? What market or performance factors determine the investor’s return? Under what scenarios would principal protection, enhanced yield, or other benefits not occur?
• What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks?
Questions for the New Product (cont’d)

- How will the firm and registered representatives be compensated? Will the offering of the product create any conflicts of interest between the customer and any part of the firm? If so, how will those conflicts be addressed?
- Are there novel legal, tax, market, investment or credit risks?
- Does the product’s complexity impair understanding and transparency of the product?
- How does this complexity affect suitability considerations or the training requirements for the product?
- How liquid is the product?
FINRA Regulatory Notice 12-03, January 2012
Post-Approval Review

• Firm should periodically reassess complex products a firm offers to determine whether their performance and risk profile remain consistent with the manner in which the firm is selling them
• Firms also should consider developing procedures to monitor how the products performed after the firm approved them
• Firms also should conduct periodic reviews to ensure that only associated persons who are authorized to recommend complex products to retail customers are doing so
Training

- Registered representatives who recommend complex products must understand their features and risks.
- Registered representatives who recommend structured products should possess a “sophisticated understanding” of the payoff structure and risks.
- The registered representative should be able to develop a payoff diagram of a structured product to facilitate the analysis of its embedded features and recognize that such a product typically consists of a bond and derivative parts.
- The registered representative also should understand such features as the characteristics of the reference asset, including its historic performance and volatility and its correlation with specific asset classes, any interrelationship between multiple reference assets, the likelihood that the complex product may be called, and the extent and limitations of any principal protection.
- The registered representative should be adequately trained to understand not only the manner in which a complex product is expected to perform in normal market conditions, but the risks associated with the product.
• 12-03 encourages firms to adopt the approach mandated for options trading accounts: would require that a registered representative have “a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the” complex product

• Firms also should consider prohibiting their sales force from recommending the purchase of some complex products to retail investors whose accounts have not been approved for options trading, particularly the recommendation of complex products with embedded options or derivatives
FINRA Regulatory Notice 12-03, January 2012
Consideration of a Customer’s Financial Sophistication (cont’d)

• Firms that permit the recommendation of complex products to retail investors whose accounts have not been approved for options trading should:
  • Develop other comparable procedures designed to ensure that their sales force does not solicit retail customers for whom complex products are unsuitable
  • Be prepared to demonstrate the basis for allowing their sales force to recommend complex products to retail investors with accounts that are not approved for options trading

• Approving an account for the purchase of complex products is not a substitute for a thorough suitability analysis
Discussions with the Customer

• The registered representative who intends to recommend a complex product should discuss with the customer:
  • The features of the product
  • How it is expected to perform under different market conditions
  • The risks and the possible benefits, the costs of the product
  • The scenarios in which the product may perform poorly

• The registered representative should consider whether, after this discussion, the retail customer seems to understand the basic features of the product
FINRA Regulatory Notice 12-03, January 2012

• Consideration of whether less complex or costly products could achieve the same objectives for the customer
  • Registered representatives should consider whether less complex or costly products could achieve the same objectives for their customers
  • For example, registered representatives should compare a structured product with embedded options to the same strategy through multiple financial instruments on the open market, even with any possible advantages of purchasing a single product
Reasonable Basis Suitability - Considerations for Approval Committees
Suitability assessments

• The reasonable basis suitability assessment is essential in discharging the product provider’s obligations

• Any assessment should take into account:
  • The generation of the product idea
  • The target market for the product, or the product’s intended purpose
  • The design of the product features
  • The types of conditions under which the product performance has been evaluated (looking at hypotheticals, at stress-testing, etc.)
  • The overall risks and rewards of the product
  • The financial and market risk associated with the product
  • Any legal risks
  • The complexity of the product
  • Reputational risks
Suitability assessments

In evaluating a potential new product, the Committee may want to consider whether:

• Competitors offer similar product
• The product pay-out is particularly complex
• The product pay-out renders the product unsuitable for certain types of investors
• The product incorporates leverage
• The product references an asset class that is well understood, or an asset class that may present particular risks or may be less well understood by retail investors
• The product references a new asset class, or a proprietary index
• The pay-out or contingencies render the product complex
• There are novel legal issues or novel tax issues
• There are particular disclosure concerns
• The format or “wrapper” in which the investment will be packaged
Suitability assessment

• Some market participants categorize or “group” products based on particular attributes and may subject certain products to heightened scrutiny—for example, some market participants identify the following products as requiring closer consideration:
  • Structured products with downside risk (RevCons)
  • Structured products with complex underlyings (like volatility or a proprietary index) or complex pay-outs
  • Structured products with no certainty of a coupon for the full tenor (like zero coupons, teasers, or knock-out coupons)
  • Long tenor structures (usually anything over 10 years)
  • Credit-linked products
Suitability assessment

• Other market participants have formulated a “matrix” approach and identified various characteristics that a Committee should consider in connection with a suitability review. Some “benchmark” their products against other products offered by competitors.
Four Quadrants of Note and Index Complexity

- Complex strategy (e.g. market-neutral, momentum, carry, negative serial correlation, etc.)
- Frequent rebalancing
- Multiple indexing levels
- Actively managed
- Broad asset class
- High embedded leverage
- Volatility control
- Infrequent rebalancing
- Direct asset exposure
- Not actively managed
- Specific asset or asset class
- Low embedded leverage
- No volatility control

- Downside protection (principal protection, buffer, etc.)
- High minimum purchase amount (> $10,000)
- High liquidity (e.g., listed, registered, allows for redemption, etc.)
- Fixed coupon

- Downside leverage
- Low minimum purchase amount (< $1,000)
- Low liquidity
- Variable or zero coupon
- Upside limitation (e.g., return cap, return hurdle, etc.)
- Unfavorable tax treatment
Suitability Assessment

• Here are some considerations that may inform the Committee’s analysis as it reviews a potential new product

• Describe the product in general, including the maximum term to maturity
  
  • Products with a longer term to maturity may be perceived as riskier, or more difficult for a potential investor to evaluate

• Provide an example of the product under current market conditions. What assumptions underlie the product? How is the product expected to perform in different economic scenarios?
  
  • The Committee should consider the likely pay-out under normal scenarios, as well as under stress scenarios. FINRA will consider whether the product is “designed to fail” or whether it offers a value proposition only under certain limited scenarios
Suitability Assessment

• What is the product’s investment objective? Is that investment objective reasonable in relation to the product’s characteristics? Does this product provide market access, or exposure to a particular investment strategy, or otherwise add to the firm’s current product offerings?

  • FINRA will consider the fundamental objective of the product (is it enhanced yield? Market access? etc.) Is the new product priced such that the potential yield is an appropriate rate of return in relation to the volatility of the reference asset based on comparable and similar investments, in terms of structure, volatility and risk in the market. For example, similar structured products based on reference assets that possess substantially similar volatility characteristics, but which offer materially different rates of return, should call into question whether the instrument with the lower yield meets the reasonable basis suitability standard.
Suitability Assessment

- How would you describe the target market for the product? Are there particular types of accounts/investors for which the product may not be appropriate?
  - Is it a retail product? High net worth/private bank client product? What are the minimum denominations? Is there a minimum purchase requirement? Is it intended for investors that seek higher yield? For investors that do not need current income?
  - Whether the economic exposure provided by the product is appropriate for the relevant class of investor, both in terms of risk and “type” of exposure
    - For example, a product providing heavily leveraged downside exposure to a particular reference asset may not be suitable for retail investors. In addition, exposure to certain types of complex “hidden assets” (for example, “skew” and “smile”) may also not be appropriate for retail investors; even if the risk of the product is not particularly high
Suitability Assessment

• When selling a product into the retail market, you should consider the types of investments typically held by retail investors and whether the proposed new product would be an appropriate component of such an investor’s investment mix;
• Whether the new product can be explained in a manner that can be reasonably expected to be understood by the relevant class of investor, and where investors in such class can be reasonably expected to be capable of evaluating the risks; and
• Whether the reference asset could be sold directly to the relevant class of investor. As a general rule, if the reference asset could not be sold directly, a structured product on such reference asset should also not be sold
Suitability Assessment

• Does the product incorporate leverage? Incorporate any algorithmic models, or quantitative strategies? What are the elements, if any, of the product that might be deemed “complex”? Could a less complex structured product be developed that could achieve the same objective?

• FINRA assumes that products that incorporate leverage are “riskier” and more difficult for a retail investor to understand and evaluate. Leverage may magnify losses in unpredictable ways. Similarly, FINRA assumes that products that incorporate a proprietary model or quantitative strategies are more complex, even if the pay-out is simple. FINRA Notice 12-03 provides examples of the types of products that may be complex

• The Committee may consider asking additional questions or formulating an additional questionnaire for products that reference an index, which may include the following considerations: Does the index use a complex strategy (e.g., market-neutral, momentum, carry, negative serial correlation, etc.)? Does the index have high embedded leverage? Is there frequent rebalancing?
Suitability Assessment

• Are there multiple indexing levels? Is the index actively managed? Does the index track a broad asset class? Does the index have a volatility control? Does the note have downside leverage? Does the note have a low minimum purchase amount (<$1,000)? Does the note have an upside limitation (e.g., return cap, return hurdle, etc.)?

• What market or performance factors determine the investor’s return? Under what scenarios would principal protection, enhanced yield, contingent protection, or other presumed benefits not be realized?

• FINRA views products that incorporate “contingencies” as more challenging for retail investors to understand. Retail investors may not understand how contingencies will affect their potential investment or their return. Products with contingencies will require more detailed disclosures; disclosures must be clear. There is also a higher risk that distributors may not understand or being able to explain the contingencies.
Suitability Assessment

• How will the distributor be compensated for offering the product (i.e., what are the associated fees paid to third parties)? Is there anything different about the fees that will be paid in connection with the distribution of this product compared to other products?
  • FINRA is concerned that a “structured product” contains embedded fees and that the “packaging” may obscure inappropriate fees or mark-ups. In addition, FINRA is concerned that the compensation paid to product manufacturers or distributors may motivate them to sell a structured product in favor of a simpler product.

• Will the offering of the product create any conflicts of interest between the investor and any part of the firm or its affiliates? If so, how will those conflicts be addressed?
  • FINRA has conducted a “conflicts of interest” sweep and has noted that structured products may involve conflicts of interest (whether in connection with the product manufacturing by the issuer’s affiliated broker-dealer; the hedging arrangements between the affiliated broker-dealer and the issuer; the index creation; any calculation agent function; distribution through private banking or advisory channels).
Recommendations

• The Committee must consider implementing a variety of tools, such as:
  • Requiring higher minimum denominations
  • Requiring minimum purchase requirements
  • Imposing restrictions on the types of potential investors
  • Limiting sales to advised channels
  • Only selling the product through particular distributors that are better suited to handle complex products
  • Providing additional training to the distributors
    • Requiring special training for personnel
  • Granting only conditional approval for a limited period of time, subject to certain requirements
  • Mandating post-approval review within a specified period of time
What Can Go Wrong – FINRA Enforcement Actions
FINRA Enforcement Actions Regarding Complex Products, Generally

- FINRA disciplinary actions allege:
  - Failure to supervise
    - Inadequate systems
    - Inadequate training
  - Unsuitable sales
    - Across the board
    - Particular horror stories — elderly or unsophisticated customers
  - False or misleading disclosures

- FINRA fined Ferris, Baker Watts LLC $500,000 for inadequate supervision of sales of reverse convertible notes to retail customers.
- Also found unsuitable sales of reverse convertibles to 57 accounts held by elderly customers who were at least 85 years old and customers with a modest net worth. The firm was ordered to pay nearly $190,000 in restitution.
- Firm failed to provide sufficient guidance to its brokers and supervising managers on how to assess suitability in connection with their brokers' recommendations of reverse convertibles.
- Additionally, the firm did not have a system to effectively monitor customer accounts for potential over-concentrations in reverse convertibles. The firm also failed to detect and respond to indications of potential over-concentration in reverse convertibles.
Firm used an automated surveillance system for suitability review of securities transactions and to monitor customer accounts for potentially unsuitable positions and activity

However, the firm's system was not configured or designed to monitor RCN transactions or RCN positions in customer accounts and the firm did not establish an effective alternative means to do so

Horror stories

- Recommended that a retired couple in their 80s, with a moderate risk tolerance and a long-term growth objective, invest more than $100,000 in an RCN – over 85 percent of their account value and more than half of their liquid net worth. Loss of over $88,000
- Recommended that a 36-year-old with no investment experience, moderate risk tolerance and a long-term growth objective, invest $95,000 in an RCN. Loss of $80,000

Additionally, the firm failed to provide sufficient guidance to its supervising managers on how to assess suitability in connection with their brokers' recommendation of RCNs
FINRA Reverse Convertible Actions – Santander Securities (April 2011)

• April 2011, FINRA fined Santander Securities
• Issues raised by FINRA:
  • Unsuitable sales
    • Citing sales to retirees
  • No process for reviewing and approving particular products before sales
  • Inadequate supervision of structured products sales
    • Citing a lack of training, a lack of suitability guidance
  • Concentrated positions in reverse convertibles
    • No detection or screening system
  • Inadequate supervision of recommendations and sales using loans from firm’s banking affiliate, to capture the spread;
    • Dramatically increased exposure to risk
FINRA CMO Actions – Northern Trust (June 2011)

• Firm used an exception reporting system for supervisory review – it flagged transactions and accounts that exceeded established threshold values for account turnover and concentration levels in a particular security or class of security

• However, the firm was unaware that the system failed to capture substantial portions of the firm’s business (43.5% for 18-month period), including:
  • all CMO trades; and
  • trades of 10,000 or more shares of stock, or 250 or more bonds.

• Therefore, the firm failed to monitor customer accounts for potentially unsuitable levels of concentration in CMOs or much of its equity and FI business.

• Horror stories
  • 26 accounts for customers over 70 years old held CMO positions over 50% of value of their accounts
  • A 92-year old widow put almost half of her net worth in a CMO with a maturity date in 2037
FINRA CMO Actions – SAMCO Cases (2009)

• Series of cases against individual brokers who made unsuitable (and fraudulent) sales of inverse floater CMOs to customers.
• Customers funded much of their purchases with margin borrowing that exceeded their entire liquid net worth and created an unsuitable level of exposure to losses.
• Therefore, the firm failed to monitor customer accounts for potentially unsuitable levels of concentration in CMOs or much of its equity and FI business.
• Horror stories
  • Conservative investors, 76 and 58 years old, opened an account with conservative investment objectives, paid for inverse floaters with deposit of $40,000 and margin loan of $60,000, and lost most of their investment.
  • low risk tolerance and unsophisticated customers, 54 and 49 years old, opened a joint account and invested in inverse floaters with $25,000 and margin loan of $37,000, and lost most of their investment.
FINRA PPN Action – UBS (April 2011)

- Related to losses suffered in connection with Lehman Brothers 100% Principal Protection Notes. The protection of principal on these notes was subject to the credit risk of the issuer
- FINRA found that UBS failed to adequately analyze suitability of sales of Lehman PPNs
- Customers who had a conservative or moderate account risk profile were more likely to rely on the firm’s representations about the 100% principal protection feature
- Therefore, the product was unsuitable for some of these customers because it was inconsistent with their investment objectives
FINRA ETF Actions (May 2012)

• FINRA sanctioned four firms for selling leveraged and inverse exchange-traded funds without supervision and without having a reasonable basis for recommending the securities.

• Leveraged ETFs seek to deliver multiples of the performance of the index or benchmark they track; inverse ETFs seek to deliver the opposite of the performance of the index or benchmark they track.

• Risks: daily reset, leverage and compounding. Thus, performance of the ETFs could differ significantly from the underlying index or benchmark when held for longer periods of time, particularly in a volatile market.

• FINRA found that the firms failed to conduct adequate due diligence regarding the risks and features of the ETFs to their retail customers, and therefore did not have a reasonable basis to recommend them.

• Also found unsuitable recommendations to customers with conservative risk profiles.
FINRA Closed End Fund Actions (July 2009)

• FINRA sanctioned two firms and suspended 5 brokers for supervisory failures that led to unsuitable short-terms sales of closed-end funds purchased in the funds’ IPOs.
• CEFs are investment companies that sell a fixed number of shares in an IPO, and then trade at a discount for some period. CEFs thus are more suitable for long-term investments.
• FINRA found that the brokers recommended sales of the CEFs at a loss, right after the penalty bid period expired, and then to use the proceeds to buy another CEF in an IPO.
• FINRA found that the firms failed to have adequate supervisory systems and procedures designed to detect and prevent unsuitable short-term trading.
• Firms also failed to provide adequate guidance to supervisors regarding problems with short-term trading of CEFs bought in an IPO.
Medical Capital Holdings VI Offering

• MedCap was a medical receivables financing company, which raised approximately $2.2 billion from over 20,000 investors through nine private placements of promissory notes.
• MedCap made interest and principal payments on its promissory notes until July 2008, when it began.
• MedCap nevertheless offered Medical Provider Funding Corporation VI through an August 2008 PPM, even though it had begun experiencing liquidity problems and stopped making payments on notes sold in two of its earlier offerings.
Provident Royalties Offerings

• Provident Asset Management, LLC, sold preferred stock and limited partnership interests in 23 private placements offered by an affiliate through more than 50 retail broker-dealers nationwide and raised approximately $485 million from over 7,700 investors.

• Some of the proceeds of the offerings were used for the acquisition and development of oil and gas exploration and development activities, but most were used to pay dividends and returns of capital to investors in the earlier offerings, without informing investors of that fact.
FINRA Private Placement Actions (cont’d)

• In 2009, the SEC obtained a temporary restraining order, an emergency asset freeze and appointment of a receiver against both MedCap and Provident.
• FINRA investigated retail sales of the offerings through a network of broker-dealers and brought numerous formal disciplinary actions.
• FINRA imposed sanctions against broker-dealer and their principals and compliance officers for failiures to conduct a reasonable investigation or for failing to enforce procedures with respect to the sale of private placements.
Reminders for Broker-Dealers
Reminders for Broker-Dealers

• Confirm that an appropriate new product approval process is in place, that it is determined to be effective, and that post-approval reviews are conducted

• Ensure that appropriate suitability guidelines are in place and adhered to by representatives/advisers
  - Consider conducting an inventory of products offered by broker-dealer: which products are “complex”?
  - Consider creating specific guidelines for “complex products”
  - Consider limiting sales of certain “complex products” to specially trained sales force and if distributors are used, then ensure distributors are adequately trained

• Assess process to vet concentration issues
  - Concentration by product type
Reminders for Broker-Dealers (cont’d)

- Review policies and procedures for structured products sales
- Ensure account opening procedures are followed
- Conduct reviews of all internal and external structured products materials
- Ensure that appropriate training is mandated
  - Special training is required for “complex products”
- Review offering procedures to ensure proper filings are made
- Review process for secondary trades
Launching an Exempt Structured Products Program in the United States: Issues for Non-U.S. Banks to Consider

Non-U.S. banks that maintain a registered medium-term note program may wish to supplement that platform with an exempt bank note program for issuances of structured products. Other non-U.S. banks may wish to make the plunge into the U.S. market for the first time. Alternatively, a non-U.S. bank may have an existing exempt program, but has never contemplated using that program for issuances of structured products. In this article, we summarize the key issues to be considered prior to launching an exempt structured products program.

Which exemptions are available, and is there any advantage to using any particular exemption?

Foreign banks may avail themselves of three exemptions from registration under the Securities Act of 1933 (the “Securities Act”). Rule 144A under the Securities Act (“Rule 144A”) and Regulation D under the Securities Act (“Regulation D”) are both transactional exemptions available to a non-U.S. bank or any other issuer, regardless of its business.\(^1\) Regulation D is a safe harbor for private placements under Section 4(a)(2) of the Securities Act. There are significant restrictions on transfer and resale for Rule 144A or Regulation D securities.

\(^1\) In this article, we refer to issuers using the Rule 144A and Regulation D exemptions as “foreign banks,” which term includes foreign financial institutions that may not be organized as a bank.
Section 3(a)(2) under the Securities Act is an exemption for securities issued or guaranteed by a “bank.” It is available for securities issued by certain U.S. branches or agencies of a foreign bank, but not to the securities of the foreign bank, except as discussed below. The Securities and Exchange Commission (the “SEC”) deems a branch or agency of a foreign bank located in the United States to be a “bank,” as defined in Section 3(a)(2), provided that the nature and extent of federal and/or state regulation and supervision of the particular branch or agency is substantially equivalent to that applicable to U.S. federal or state banks doing business in the same jurisdiction.

The securities of a foreign bank are exempt under Section 3(a)(2) if they are guaranteed by a bank. Many non-U.S. banks use this structure by having the U.S. branch or agency guarantee securities issued by the non-U.S. headquarters or branch. Another alternative is to have the U.S. branch or agency act as the guarantor for securities issued by a finance subsidiary of the foreign bank. The guarantee is a legal requirement to qualify for the exemption; investors will typically not be looking to the U.S. branch or agency for payment, but rather to the home office. The guarantee must be full and unconditional.

Section 3(a)(2) bank securities have no investor or resale limitations, except as discussed below. Section 3(a)(2) bank securities are generally freely transferrable and “public,” as opposed to “private” securities issued under the Rule 144A or Regulation D transactional exemptions.

Why might a non-U.S. bank consider an exempt program in addition to an existing public program?

Any bank that already issues under a registered program may consider whether an exempt program would simply be redundant, or actually provide benefits to it. Among the reasons why many issuers maintain an exempt program in addition to their registered program are:

- Particularly in the Rule 144A market, some investors wish to keep the terms of the securities that they purchase confidential, which is not feasible in connection with a registered offering.

- Some types of underlying assets are not contemplated by the SEC’s "Morgan Stanley letter" relating to registered structured notes, including credit-linked notes and small-capitalization stocks.

- Practitioners generally believe that the potential for federal securities law liabilities in the event of a misstatement or omission in the offering documents is somewhat reduced in the case of an exempt offering. This feature might be particularly attractive in the case of complex securities or complex underliers that are used in an offering sold to institutional investors.

Does the foreign bank need to consult with any U.S. regulator prior to launching the program?

A foreign bank issuing under the Rule 144A exemption or the Regulation D safe harbor would not have to consult with, or be regulated by, any U.S. regulatory entity prior to issuing its securities, nor would it have to use a U.S. branch or agency to issue under those exemptions.

A U.S. branch or agency of a foreign bank should consult with its state and federal regulator prior to launching a structured product program. U.S. branches or agencies that have chosen to be regulated as a state bank (typically in New York) should consult with their state banking regulator, the New York State Department of Financial Services (the “NYDFS”), and the Federal Reserve Bank of New York.

There are no formal federal or New York state bank regulatory application, registration or notification requirements for the issuance of notes by a New York branch. However, advance consultation with the NYDFS on any structured notes

---

2 For an extensive discussion of Section 3(a)(2) bank note programs, please see our FAQ at http://www.mofo.com/capital-markets-services/?op=richTextB&ajax=no.
program should be considered. The NYDFS may want the opportunity to review these types of programs, and to approve/not object to the terms and conditions of the program or a proposed offering.3

Branches or agencies in other states should contact their state and federal regulators.

If the U.S. branch’s or agency’s primary regulator is the Office of the Comptroller of the Currency (the “OCC”), the program must comply with 12 C.F.R. Part 16, the OCC’s Securities Offering Disclosure Rules (the “OCC Rules”), as more fully discussed below. U.S. branches or agencies that have elected to be federal branches or agencies are regulated by the OCC.

An uninsured state-regulated U.S. branch of a foreign bank is subject to the deposit regulations of the International Banking Act of 1978, as amended.4 Some types of notes issued by a state-regulated U.S. branch of a foreign bank could be viewed as a “deposit” by the branch’s state or federal regulators within the meaning of Section 3(l) of the Federal Deposit Insurance Act.5 In order to avoid being considered a prohibited retail deposit of an uninsured domestic branch of a foreign bank, those types of deposits cannot be offered in denominations that are less than the “standard maximum deposit insurance amount,” which is currently $250,000.6 This limitation does not apply to notes issued by a foreign bank and guaranteed by its U.S. branch, and accordingly, that structure is more typically used for programs that are not planned to be limited to institutional investors.

Comparable requirements are applicable to an uninsured U.S. branch that is regulated by the OCC under the OCC’s deposit-taking rules.7 These restrictions are subject to a variety of exceptions set forth in the OCC’s rules. The OCC is also authorized to grant exemptions to these limitations if the branch can demonstrate that the proposed activity is consistent with the policy described in 12 C.F.R. § 28.16(a).

Are there any restrictions on investors?

Foreign banks and U.S. branches or agencies issuing notes under Rule 144A must sell only to “qualified institutional buyers,” as that term is defined in Rule 144A(a)(1) (“QIBs”). Sales to individual retail investors are prohibited. Notes sold under Rule 144A also have significant restrictions on transfer; resales to other QIBs are allowed, but transfers to non-QIBs are subject to significant restrictions, which often prevent these transfers from occurring.8 General solicitation can now be used in a Rule 144A offering, but sales can only be made to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.9

Foreign banks and U.S. branches or agencies issuing structured notes under Rule 506 of Regulation D can sell to an unlimited number of “accredited investors,” as that term is defined in Rule 405 under the Securities Act, and up to 35 non-accredited investors who meet certain “sophistication” requirements,10 if the appropriate resale limitations are imposed, any applicable information requirements are satisfied and the other conditions of the rule are met. General solicitation is now permitted in certain Rule 506 offerings, provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors. A foreign bank can opt to issue structured notes under Rule 506 without using general solicitation.

---

3 See also the note below on issuances by New York agencies.
5 In the past, the FDIC stated that it believed that certain types of bank notes issued by insured depository institutions, such as instruments marketed as “deposit notes,” fall within Section 3(l)(1) of the Federal Deposit Insurance Act. See 60 Fed. Reg. 66,952 (1995). In contrast, the FDIC has stated that a bank product that is structured as a non-principal protected instrument (like most (but of course, not all) structured notes) is a non-deposit obligation of the bank. See Letter of Joseph A. Genova Jr., FDIC Senior Regional Attorney to Bankers Financial Services Corporation (February 27, 2002; available at https://www.indexedcd.com/bankers/public/datafiles/regulatory_review_fdic_insurability.pdf).
6 12 C.F.R. §§ 347(e), (v).
7 12 C.F.R. § 28.16.
8 For a detailed discussion of Rule 144A programs, please see our FAQ at http://www.mofo.com/capital-markets-services/?op=richTextB&ajax=no.
9 To date, structured note issuers have not made much use of general solicitation in Rule 144A offerings.
10 Under Rule 506(b)(2)(ii), each purchaser in a Rule 506 offering who is not an accredited investor must possess, or the issuer must reasonably believe before the sale of the securities that such purchaser possesses, either alone or with his or her purchaser representative, “such knowledge and experience in financial or business matters that he [or she] is capable of evaluating the merits and risks of the proposed investment.” Generally, issuers of structured products using the Rule 506 exemption do not offer or sell securities to non-accredited investors.
Whether or not general solicitation is used in a Rule 506 offering, the new “bad actor” disqualification provisions will apply. These provisions prohibit issuers and others such as underwriters, placement agents, directors, executive officers, and certain shareholders of the issuer from participating in a Rule 506 offering if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws.11

Structured notes issued under Rule 144A or Rule 506 of Regulation D are “restricted securities,” as that term is defined in Rule 144(a)(3) under the Securities Act, and are subject to restrictions on resale.

There are no minimum denomination requirements for a Rule 144A or Rule 506 offering of structured notes; however, concerns about preventing confusion between bank deposits and deposit products and bank notes may cause banks to issue in denominations of at least $1,000. In addition, many bank notes are issued in higher denominations, in order to help address investor suitability concerns.

A U.S. branch or agency that is regulated by a state, rather than the OCC, can issue Section 3(a)(2) bank notes to all investors, including retail. However, an agency of a foreign bank subject to New York state banking regulations would have to notify the Superintendent of the NYDFS of the upcoming transaction, and, absent objection from the Superintendent within 30 days of such notice, would be able to sell only to certain authorized institutional purchasers in minimum denominations of $100,000.

Under the OCC Rules, a federal branch or agency can issue bank notes under any of three exemptions from the OCC’s registration requirements:

- Part 16.6 of the OCC Rules provides for issuances of non-convertible “investment grade” debt to accredited investors, in $250,000 minimum denominations, subject to certain disclosure requirements and a post-sale filing. Any resale of a bank note under Part 16.6 must be in a minimum denomination of $250,000.

- Part 16.5 provides exemptions for issuances of securities under Rule 144A or Regulation S under the Securities Act.

- Part 16.7 provides an exemption for issuances of securities under Regulation D.

Issuances of structured bank notes by a federal branch or agency under Rule 144A or Regulation D in compliance with the OCC Rules would be subject to the restrictions on the manner of offering, and the OCC’s deposit-taking rules, each as discussed above.

**What type of financial statements are required in the disclosure documents?**

**General.** There are several threshold questions about financial statement requirements, and the answers will depend on the identity of the issuer and the exemption used for the issuance. For example, a foreign bank issuing structured notes in the United States under Rule 144A or Rule 506 would use its own financial statements. Preferably, the financial statements should be in English, audited, in a form understandable to U.S. investors and publicly available. U.S. GAAP or IFRS are the choices that are most widely used in the U.S. market. In registered offerings, financial statements prepared under other accounting principles need to include a U.S. GAAP reconciliation footnote, and the bank and its distributors may wish to consider whether this is a desirable step for a non-registered program. For a continuous offering program, the bank should also publish unaudited financial statements, at least on a semi-annual basis. The statistical disclosures required in a registration statement by Industry Guide 3, Statistical Disclosure by Bank Holding Companies, may also be desirable to include.

Often, the most convenient situation would be if the foreign bank could incorporate its audited financial statements from a Form 20-F or 40-F filed with the SEC.12 Although not required for an exempt offering, issuers incorporating their financial

---

11 For a detailed description of the bad actor provisions applicable to Rule 506 offerings, please see our Client Alert.

12 This would be the case for a foreign bank that currently maintains a shelf registration statement, and wishes to supplement its registered offerings with an exempt platform.
statements from a Form 20-F may wish to ensure that the Form 20-F is filed prior to the financial statements becoming more than 15 months old.\textsuperscript{13}

An alternative would be if the foreign bank’s audited annual financial statements (and unaudited semi-annual or quarterly financial statements), meeting the requirements of its home jurisdiction, are posted and regularly updated on a website or an electronic delivery system generally available to the public in its primary trading market. Those financial statements can be incorporated by reference into the offering document.

Because a U.S. branch or agency will not have its own financial statements, market practice is to use the financial statements of the parent foreign bank, as they are recognized as one enterprise.

In all situations, the lead distributor for the proposed structured notes program should be consulted as to the form of the financial statements. Variations from the use of a Form 20-F or 40-F, and from U.S. GAAP or IFRS, may raise concerns with the distributors.

**Rule 144A Offerings.** Foreign banks, and U.S. branches or agencies of a foreign bank, issuing structured notes under Rule 144A, in each case not subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") nor exempt from reporting under Rule 12g3-2(b) thereunder, must make available to any purchaser of a structured note and a prospective purchaser designated by the holder the financial information required by Rule 144A(d)(4). That information includes financial statements for the last two fiscal years, which should be audited to the extent reasonably available.

**Part 16.** Federal branches and agencies using the OCC Part 16.6 exemption must provide the OCC with the information specified in Rule 12g3-2(b) under the Exchange Act and provide investors with the information required by Rule 144A(d)(4)(i).

**Regulation D.** Foreign banks, or U.S. branches or agencies thereof, issuing under the Rule 506 exemption (including issuances by federal branches or agencies under OCC Part 16.7) to non-accredited investors must satisfy the requirements relating to financial and other information to be provided to non-accredited investors included in Rule 502(b) under the Securities Act. As noted above, this step can cause offerings to these types of investors to be impractical or expensive, and are not common in the structured note market.

**What regulatory issues arise from using a New York branch as the issuer, as opposed to acting as the guarantor?**

While there are no specific rules on how New York branches of foreign banks may use the proceeds of their funding activities, Federal and New York bank regulatory authorities will want to understand the purpose of the issuances, where and how the funds will be used, and how the market risks will be hedged. In addition, regulators are likely to closely scrutinize any proposal to repatriate to the home office the proceeds of any funding activities, including the proceeds of notes issued by a New York branch. Federal and state authorities routinely monitor the exposures of U.S. branches to their home offices and may raise supervisory questions if those exposures become excessive. These determinations are made on a case-by-case basis.

The NYDFS currently does not have rules or regulations imposing limits on on-lending. However, the NYDFS has an informal policy that may limit the amount it may be owed by its head office or any other affiliate to 50 percent of the assets of any branch or agency.

The NYDFS has stated that it no longer strictly applies the on-lending policy to limit the size of net due from head office accounts of New York state-licensed branches and agencies. Rather, the NYDFS applies the policy only to prohibit the use of a New York branch license solely as a funding vehicle for a bank’s head office, and as a tool to monitor the asset quality of the branch or agency, especially in light of concentration of country exposure. If the institution of the head office

\textsuperscript{13} See Item 8.A.4 of Form 20-F. This is a requirement for offerings for registered securities, and depending upon the nature of the program, the dealers may expect that the financial statements available to purchasers in an exempt offering be just as “fresh.”
is strong, the NYDFS is likely to be less concerned with a large amount due from the head office. A bank that plans to substantially increase its due from the head office because of on-lending of funds raised in the capital markets may wish to discuss the matter in advance with the NYDFS.

New York branches of foreign banks are also subject to asset segregation requirements that are intended to ensure the ability of the New York branch to satisfy its covered liabilities. In turn, any notes issued or guaranteed by a New York branch would presumptively be considered liabilities for purposes of these financial regulatory requirements.

The NYDFS also will want to understand how the market risks arising from the notes will be hedged, and by which entity. Consideration should be given to whether the branch has the authority to carry a hedge book, and whether the branch has systems in place to hedge. Does the branch have people experienced in derivatives transactions and analyzing risk? Who will be the hedging counterparties? Hedging transactions should also be analyzed to avoid any violation of the affiliate transaction restrictions of Sections 23A and 23B of the Federal Reserve Act, should a hedging counterparty be an affiliate of the bank.

How early in the process should the issuer choose a lead dealer for the program?

Very early. Many banks have an affiliated broker-dealer that will be part of a structured note program. That affiliated dealer may or may not have expertise in the structured products market. If the affiliated dealer is unfamiliar with the structured products market and the related distribution and sales issues, the issuer will likely seek to engage an unaffiliated dealer that is familiar with the structured products market, for the following reasons:

- The Financial Industry Regulatory Authority, Inc. (“FINRA”) and a variety of other U.S. regulators are focused on the suitability of sales of structured products, particularly to retail investors. An issuer will benefit from engaging a dealer that has experience in the structured products market, and that has established internal compliance procedures to ensure that its sales of structured products do not violate FINRA’s suitability rule.

- The dealer may have particular views and preferences with regard to acceptable financial statements (as discussed above) and forms of documentation (as discussed below). It is better to take into account the dealer’s preferences and suggestions early in the process instead of completing documentation that is later found to be unacceptable to unaffiliated dealers due to market practices and preferences.

- If the dealer plans to distribute through third-party broker-dealers that will not be signed up as dealers on the structured note program, the issuer should inquire as to the dealer’s “know your distributor” practices and procedures, with a view to preventing any future reputational risk.

- The available FINRA filing exemption will depend on whether an affiliated or unaffiliated broker-dealer is used for the program, and whether “conflicts of interest” (as defined by FINRA) disclosure should be included in the offering circular.

- The lead dealer will want to start its diligence early in the process in order to identify any potential issues, whether relating to the issuer’s creditworthiness, disclosures in the offering documents, or other areas.

What types of documents are needed for the program?

Although the names are different, the documentation for a structured bank note program is similar in many respects to that in a registered offering:

- **Offering Circular:** Because an exempt offering is subject to the anti-fraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, the information in an offering circular tends to be consistent with that in a prospectus for a registered offering, even though there is no specific content requirement under the Securities Act or the banking regulations. At a minimum, the offering circular should contain the information required for an offering by a national bank under OCC Part 16.6—a description of the business of the issuer similar to that
contained in a Form 10-K, a description of the terms of the bank notes, the use of proceeds and the method of distribution.

- Disclosure about a branch or agency will be very limited, and often consists of only the address, primary business lines and date of establishment. Because the branch or agency is the same legal entity as the parent or headquarters, disclosure about the parent or headquarters is typically sufficient.

- If a guarantee structure is used, the terms of the guarantee must be fully disclosed.

- Structured notes issuers also may use forms of “product supplements” for particular structures, and a “pricing supplement” containing the terms of a particular note being offered.

- **Distribution Agreement**: This document would also be very similar to a distribution agreement for a registered offering. Here, early contact with the lead dealer will be helpful in identifying a form that is acceptable for that dealer and that is also market standard. The issuer should not necessarily attempt to make this document too “issuer-friendly” if, for example, the lead dealer is an affiliate of the issuer. Doing so may make it difficult to add third-party dealers in the future.

- Careful consideration should be given to the comfort letters and the scope of legal opinions to be delivered at the commencement of the structured notes program and also on a periodic basis. Usually, an annual comfort letter that occurs shortly after the issuance of the audited financial statements will be delivered, and semi-annual or quarterly comfort letters will be delivered after the issuance of the periodic, unaudited financial statements. The opinions delivered, usually on a quarterly, semi-annual or annual basis, will cover corporate matters (e.g., due incorporation, no conflicts, no litigation), regulatory matters (compliance with banking regulations, no registration required under the Investment Company Act of 1940 (the “1940 Act”)) and also include a Rule 10b-5 disclosure statement.

- Counsel should be consulted early on in the process in order to negotiate the scope of the opinions, and to sort out delivery of the opinions between internal and external counsel. Internal counsel may not be comfortable giving certain opinions, while external counsel, if not regularly engaged by the issuer, may not be in a position to give one or more of the corporate opinions described above. For example, the due incorporation, no conflicts, no litigation and regulatory compliance opinions are often given by internal counsel, while the opinions on the availability of the securities or transactional exemption and the 1940 Act exemption are often delivered by external counsel.

- Does the issuer have a designated underwriters’ counsel? If so, and if they are going to play a role in the structured products program, they, too, should be consulted early on in the process. They will provide comments on, and have a view about, the program documentation. If the issuer is new to the structured notes market, they may want to designate underwriters’ counsel to help guide them through the process. Designated underwriters’ counsel may be required to deliver a letter as to the absence of misstatements or omissions in the offering documents.

- The issuer should plan for regular periodic diligence sessions, involving document review by outside counsel and telephonic meetings with the dealers. The issuer’s financial and legal teams should be available to discuss financial, legal and regulatory issues. These diligence sessions are normally conducted immediately after the publication of the issuer’s annual and periodic financial statements.

- **Paying Agency Agreement**: The issuer should identify the party that will be the paying agent for the bank notes. Some issuers use an affiliated bank for this purpose. The form of paying agency agreement will typically be specified by the paying agent, with some input from the lead dealer.
Drafting Process. As a threshold matter, the issuer should identify the correct entities and individuals within its organization to be tasked with reviewing documents, with a goal to avoid last minute changes required by a particular internal group or department that has not been consulted.

Conclusion

There is a lot of spadework to be done by a foreign bank prior to launching an exempt structured products platform in the United States. Issuers would be well served to work with their counsel and planned distributors early in the process to identify the necessary steps and required action items.

“Big-Boy Letters” Revisited: Pharos Decision Upheld by the Sixth Circuit

Introduction

In our December 18, 2012 issue of Structured Thoughts, we examined a district court case that addressed the effectiveness of “Big-Boy Letters” in connection with a private sale of securities. “Big-Boy Letters” contain, among other provisions, representations that the investor is a sophisticated party that does not need to rely on the issuer of the relevant product or on the issuer’s agent. Additionally, these letters frequently include a waiver of all claims against the seller alleging the nondisclosure of non-public information about the issuer that may be known by the seller.

There has been some question as to the enforceability of Big-Boy Letters, because waivers of liability for securities fraud are void under Section 29(a) of the Securities Exchange Act of 1934. However, in October 2012, the district court in In re Nat’l Century Fin. Enterprises, Inc., Inv. Litig., 905 F. Supp. 2d 814 (S.D. Ohio 2012) (“Pharos”) granted summary judgment in favor of the defendant, Credit Suisse Securities, LLC (“Credit Suisse”), which was a placement agent in a private placement of securities that lost their full value. The court held that the parties’ Big-Boy Letter negated an element of the investor plaintiff’s, Pharos Capital Partners (“Pharos”), claim for securities fraud. The language of the letter was found to preclude a finding of justifiable reliance on the part of Pharos. As justifiable reliance is a necessary element of a successful fraud claim, the court granted Credit Suisse’s motion for summary judgment.

Sixth Circuit Review

In an October 2013 per curiam opinion, the Sixth Circuit Court of Appeals reviewed and roundly upheld the district court’s decision in Pharos. The Sixth Circuit court found that the district court correctly held that Pharos could not justifiably rely on any statement made by Credit Suisse, because Pharos was a sophisticated investor and had signed a Big-Boy Letter explicitly disclaiming such reliance. In addition, the court highlighted that Pharos had failed to present any particular evidence of reliance or evidence that Credit Suisse had knowledge of material information that could not be uncovered by an outside investor.

This decision illustrates the utility of using carefully drafted Big-Boy Letters in connection with the offering of sophisticated structured products. A Big-Boy Letter will not waive liability for securities fraud, but it can eliminate a critical element of such a claim and thereby reduce the liability risk for issuers and underwriters involved in these offerings.

16 Id. at *1, *2.
SEC Addresses Potentially Misleading Fund Names

In recent years, the SEC’s Division of Corporate Finance and Office of Capital Market Trends have addressed issues relating to potentially misleading names for structured notes. This issue was particularly relevant to notes with a name that included a phrase such as "principal protected."

Now, it’s the Division of Investment Management’s turn. The division is addressing funds using names that suggest safety or protection from loss.

In Guidance Update No. 2013-12, the staff stated that fund names suggesting safety or protection from loss may contribute to investor misunderstanding of investment risks. The staff said that it recently requested that some existing and new funds change what it believes were misleading names. The staff encourages funds that expose investors to market, credit or other risks, and whose names suggest safety or protection from loss, to reevaluate their names.

In particular, the staff raised concerns about funds with names that include the terms "protected," "guaranteed" and the like, when used "without additional qualification." High on the staff's watch list are funds that use the term "protected" in their names and seek to manage volatility by investing a portion of their assets in cash, short-term instruments or short positions on exchange-traded futures.

Funds that offer third-party principal protection against NAV shortfall also concern the staff. The staff said that funds that contract with third parties to make up NAV shortfalls should not use the term “protected,” unless the fund’s name adequately communicates the limitations of the “protection.” It is not enough, the staff cautioned, merely to disclose the limitations of third-party protection in the text of the prospectus. Rather, the name itself must reveal those limitations.

In conclusion, the staff encouraged investment advisers and funds’ boards of directors to carefully evaluate any fund name that suggests safety or protection from loss. These funds may consider whether a name change is appropriate to address any potential for investor misunderstanding.

What to Expect in 2014?

Over the last few years, we all have become fairly adept at expecting and addressing the unexpected; however, it still remains useful at year-end to consider what’s on the horizon. Here are our thoughts on what to expect in the structured products area in 2014.

Dodd-Frank-Related Developments

The Volcker Rule: Probably the most anticipated (or dreaded) rulemaking, the Volcker Rule was expected in December 2013, but it now seems more likely that we will see a new rule in early 2014. Although the Volcker Rule is not specifically focused on structured products, it will have an effect on this market. The rule will affect the ability of broker-dealers to maintain an inventory of structured products for market-making purposes or to accommodate clients who would like to trade in or out of structured products issued by the broker-dealer’s affiliated public bank holding company parent.

Section 621 of the Dodd-Frank Act: This is the neglected “step-child” to the Volcker Rule, which addresses conflicts of interest. Back in 2011, the SEC released a proposed rule (Rule 127B of the Securities Act) to implement the Dodd-Frank provision. The proposed rule would generally prohibit certain persons involved in the structuring, creation and distribution of an asset-backed security from engaging in transactions within one year after the date of the first closing of the sale of such ABS that would involve or result in a material conflict of interest with respect to any investor in such ABS. Depending on the ultimate definition of “asset-backed security” for these purposes, certain structured products may be covered by the rule’s prohibition on conflicts.
Title VII: We recently wrote about the effect of Title VII on the hedges associated with structured product issuances (http://www.mofo.com/files/Uploads/Images/131015-Structured-Thoughts.pdf). The CFTC has finalized most of the rules relating to swaps. We anticipate that we will have greater clarity in 2014 from the SEC relating to the rules applicable to security-based swaps.

CPOs: Although the Staff of the CFTC has provided guidance on various types of vehicles that should not be viewed as commodity pools, it is still necessary to consider each existing or proposed structure that uses a trust or other collective investment vehicle to offer structured products in which the trust engages in swaps activities. The CFTC exemptive relief stops short of addressing trusts that are used to issue credit-linked or insurance-linked notes, so these transactions merit special attention.

Removing References to Ratings: One of the objectives of the Dodd-Frank Act was to ensure that regulations did not incorporate references to credit ratings as that might cause undue reliance by investors and others on ratings. The banking agencies and the SEC have amended many of their rules to eliminate references to ratings; however, this task has not been completed. For example, the SEC has not finalized amendments to Regulation M to eliminate ratings. We discussed the SEC’s proposals in a prior issue (http://www.mofo.com/files/Uploads/Images/110620-Structured-Thoughts.pdf). Depending on the reformulation, this may have an effect on structured products offerings, such as variable price re-offer deals.

Fiduciary Duty: The SEC (and the securities industry) remains focused on finalizing the duties of care of broker-dealers. The Dodd-Frank Act required that the SEC consider the appropriateness of imposing a fiduciary duty or heightened duties on broker-dealers. Following discussions regarding the many comment letters submitted to the SEC by industry groups, there is little consensus regarding the types of additional duties that may be imposed on broker-dealers. However, November 2013’s vote of the SEC Investor Advisory Committee to recommend that the SEC adopt fiduciary duties on broker-dealers increases the likelihood of significant changes. In the structured products world, where most of the issuers rely on their affiliated broker-dealers to structure, distribute and hedge notes, and many notes are distributed through proprietary channels, the imposition of a fiduciary duty would have a disparate impact.

Bank Capital and Related Rules: The U.S. banking agencies continue to work to finalize the rules implementing the Basel III framework in the United States. Given that U.S. issuers of structured products are financial institutions subject to the regulatory capital rules, and some buyers of structured products are insurance companies also subject to certain of these rules, the incentives or disincentives created by this framework may have an effect on the market.

FINRA Developments

FINRA remains keenly focused on the structured products market, and during this past year FINRA has issued various investor alerts and regulatory notices that relate to structured products. In 2014, we anticipate that FINRA will continue to emphasize:

The Importance of KYD: Given that distributors are interacting with retail clients, FINRA has noted that issuers and their affiliated broker-dealers must conduct appropriate diligence of their distributors.

Suitability Determinations and Policies: FINRA has provided additional guidance in the form of FAQs and also its perspective on effective suitability policies. We anticipate that FINRA will pay close attention to the policies and procedures developed by member firms, especially for “complex products.”

Conflicts of Interest Policies and Disclosures: FINRA’s recent report on its conflicts of interest review is likely only the first of many communications on this topic. In the report, FINRA advises that it will be monitoring broker activities in this area, and will consider additional regulations, if needed.

Reverse Inquiry: Offerings that begin their lives as reverse inquiry transactions and then are more broadly offered and sold seem to be an area that is under scrutiny.
**Heightened Duties in Respect of Complex Products:** In all of its communications, FINRA reminds member firms that they have heightened duties when recommending complex products. It is unlikely that FINRA will provide any more detailed guidance, beyond that provided in notice 12-03, on particular products that it views as "complex."

Member firms should review, among other things: (1) Their KYD policies and procedures; (2) their new product approval process to make sure that it addresses issues specific to complex products as well as conflicts of interest; (3) their suitability policies and procedures, as well as training segments that discuss suitability obligations; and (4) ensure that for offerings that started as a reverse inquiry before broadening the offering to include retail investors, there is a process in place to confirm that the offering would be appropriate for a retail investor.

**Performance Data:** We are hopeful that FINRA will provide guidance on the use of performance data in marketing materials. As we have discussed before ([http://www.mofo.com/files/Uploads/Images/130426-Structured-Thoughts.pdf](http://www.mofo.com/files/Uploads/Images/130426-Structured-Thoughts.pdf)). FINRA does not permit the use of hypothetical historical index performance data in marketing material; however, this data may be included in “issuer materials.” Needless to say, this leads to anomalous results.

**144A Data:** the SEC has approved FINRA’s rule change to permit the dissemination of trade data through the TRACE system for 144A offerings. It is not clear when this change will take effect, but it may lead to greater transparency for structured product offerings completed on a 144A basis.

**Other SEC Developments**

Above, we mention a number of rulemakings required to be undertaken by the SEC and/or other agencies. In addition to those mandatory rulemakings, we would expect that the SEC will continue to monitor estimated value and other disclosures in structured product offering documents, and in some cases, suggest revisions. We also anticipate that the SEC’s Office of Compliance Inspection and Examinations (OCIE) may ask broker-dealers active in the area about their policies and procedures in calculating estimated value or pricing structured products.

**PRIPs**

Following a European Parliament vote in November 2013 on the proposed PRIPs regulation, trilogue negotiations between the European Parliament, the Council of the European Union and the European Commission are expected to begin in 2014 under the Greek Presidency of the Council.

The PRIPs regulation is intended to harmonise the disclosure and transparency requirements for the offering of retail investment products (including products issued in the form of securities, fund interests, deposits and life assurance polices) by requiring the production of a short, highly standardised disclosure document (called a “Key Information Document” or “KID”) to aid comparison of different products originating from different financial industry sectors.

Following the draft EU Commission Regulation on PRIPs published in July 2012, compromise drafts have been published by the Council and in November 2013, a draft has been approved by the EU Parliament. There are significant differences between the various drafts that need to be addressed in the trilogue.

Of particular focus during the trilogue negotiations will be the following proposals:

- **scope** – the EU Commission and Council draft definitions of “investment product” move away from the requirement for there to be “packaging” of the product but still envisage indirect exposure to some type of underlying asset or index. The EU Parliament draft proposes that investment products generally be in the scope of the definition with an exemption for certain vanilla products.

- **liability for the KID** – this will attach to the product manufacturer (with a possible “product seller annex” containing information for which the product seller will be responsible). Still to be agreed are the burden of proof as to liability and whether this will fall on the investor or the product manufacturer.

- **length** – proposed maximum length of two double-sided A4 pages, plus the seller annex.
• *content* – in addition to the European Commission proposals, suggestions of inclusion of a “complexity label” for complex products, and a link to an online fund calculator for investors to calculate the end value of their investment, after fees and costs. Discussion also as to whether the KID is to be “standalone” or is envisaged as a summary document to be considered in conjunction with a prospectus or other similar document.

• *other product regulation proposals by the EU Parliament* – a product approval process adopted by the manufacturer to ensure compatibility of the product and its target market, new product intervention powers for regulators, a risk management process to be adopted by the manufacturer to measure and monitor the product’s risk profile at any time, restrictions on the structure and methodology of the product’s payoff.

**MiFID**

The proposed MiFID II Directive and MiFIR Regulation are currently scheduled to be considered at the EU Parliament’s plenary session to be held between 9 and 12 December 2013.

• Most relevant to structured products will be provisions relating to:
  • increased investor protections
  • increased product intervention powers for regulators
  • required exchange trading of certain products deemed sufficiently liquid
  • greater regulatory capture of different trading venues
  • pre-trade transparency for traded structured products and derivatives
  • market access for non-EEA firms for provision of financial services and products

**EMIR**

Although parts of the EMIR regulation are already in force, the main provisions relating to compulsory clearing of certain classes of OTC derivatives require further rulemaking and determinations by the European Commission and the European Securities Markets Authority, which are expected during the course of 2014. In addition, the compulsory reporting of derivatives trades to repositories will become effective in February 2014.

---

**Nasdaq Quotation Service to Provide Quotes**

The Nasdaq OMX Group Inc. recently announced that it will be launching a program pursuant to which it will disseminate pricing information on structured products using its Mutual Fund Quotation Service. There will be an initial fee for inclusion of a tranche of notes on the service.

Issuers and their affiliated broker-dealers may want to consider the advantages and disadvantages associated with this service. Given that regulators and the popular press regularly note that there is a lack of transparency in the market for structured products, the dissemination of pricing information may be helpful. This information may be helpful for distributors who sell notes offered by various issuers, as it will provide ready access to comparative pricing information. Funds and insurance company buyers may find it beneficial to have pricing information to permit them to mark their positions. Having such information regularly disseminated also may help in establishing that there is a two-way market for these securities for purposes of other regulatory requirements, such as Volcker Rule requirements. However, it also raises concerns if the pricing information is inconsistent with the estimated values ascribed to the securities at the time of offer, and if subsequent to that, the pricing information fails to reflect accurately the value of the securities. Moreover, pricing information may lead to confusion among investors, who generally should view products as buy-and-hold...
investments, if they are led to believe that these are securities with a liquid secondary market and may erroneously trade in or out of the securities.

LinkedIn

We have created a LinkedIn group, StructuredThoughts. The group will serve as a central resource for all things Structured Thoughts. For example, we have posted on the page all back issues of Structured Thoughts. From time to time, we will be disseminating news updates through the LinkedIn group. For updates, we invite you to join the group: http://www.linkedin.com/groups/StructuredThoughts-6547296?home=&gid=6547296&trk=anet_ug_hm.

Structured Products Conference: Regulation, Legal and Compliance Issues and Bootcamp Training Sessions

On Tuesday, December 10, 2013, the Structured Products magazine conference will take place in Washington, D.C. Key regulators from the SEC and FINRA, together with leading industry participants, will discuss important issues facing the industry. After these presentations, Morrison & Foerster attorneys will deliver a series of five bootcamp classes on a range of legal and compliance issues relating to structured products.

The conference will be held at the Washington Marriott at Metro Center, 775 12th Street N.W. To obtain the conference schedule, and to register, click here: http://www.structuredproducts washington.com/static/agenda

Bootcamp topics include:

- Bootcamp 1: New product approval: We will discuss FINRA’s guidance; what it means for market participants; industry standards for new product approval processes and procedures; and how FINRA’s guidance relating to investor suitability comes into play.

- Bootcamp 2: Dealing with distributors: We will discuss know-your-distributor policies and practices, training for distributors, allocation of responsibilities as between product manufacturers and distributors, and structuring dealer relationships.

- Bootcamp 3: Compliance concerns: The compliance Kitchen-Sink presentation: We’ll address everything from training policies for structured products marketers, to policies relating to monitoring product concentration in customer accounts, secondary market repurchases and trading in and out of products.

- Bootcamp 4: Disclosure issues: We’ll discuss estimated value disclosure; issues in deriving those numbers; variable price reoffering disclosure practice; and some of the unique disclosure issues raised by the use of novel or proprietary indices.

- Bootcamp 5: Taxation of financial products: This session will provide an update on recent federal income tax developments involving financial products including a discussion of the mark-to-market proposal for financial derivatives that is being floated in Congress as part of fundamental tax reform and an update on FATCA.


Morrison & Foerster named Legal Leader, 2013 by mtn-i at their Americas Awards. Two of our 2012 transactions were also granted awards of their own as a result of their innovation.

Morrison & Foerster named European Law Firm of the Year, 2013 by Derivatives Week at their Global Derivatives Awards.

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life sciences companies. We’ve been included on The American Lawyer’s A-List for 10 straight years, and Fortune named us one of the “100 Best Companies to Work For.” Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com. © 2013 Morrison & Foerster LLP. All rights reserved.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.
FINRA gives member firms a thumbs up on suitability rule compliance

Daniel Nathan and Ana-Maria Ignat

Abstract

Purpose – The purpose of this paper is to interpret Financial Industry Regulatory Authority (FINRA) Regulatory Notice 13-31, which provides practical advice to member firms about how FINRA will be examining for compliance with the rule, some findings about failures to comply and a set of best practices for compliance.

Design/methodology/approach – The paper explains the three suitability obligations set forth in Rule 2111, the mechanics of FINRA’s suitability examinations, overall findings from FINRA’s recent suitability examinations, and some measures and practices FINRA has highlighted that could bolster a firm’s suitability-focused supervisory and compliance procedures.

Findings – The Notice provides a wealth of information on the types of approaches, systems, procedures and practices that member firms have been using and that FINRA has determined to be most effective in ensuring compliance with the suitability rule.

Practical implications – Although other ways to comply with the rule certainly exist, member firms should review the Notice and consider incorporating the practices discussed or practices likely to achieve similar outcomes.

Originality/value – The paper provides practical guidance from experienced financial services lawyers.

Keywords United States of America, Financial Industry Regulatory Authority (FINRA), Suitability

Paper type Technical paper

Having issued a new suitability rule and explicated it for the industry, on September 25, 2013, the Financial Industry Regulatory Authority (FINRA) took the next step and issued Regulatory Notice 13-31[1] (“Notice”), providing practical advice to member firms about how it will be examining for compliance with the rule, some findings about failures to comply and a set of best practices for compliance. The good news is that FINRA’s examinations have found that firms for the most part have adopted policies, procedures and systems to address the requirements of the suitability rule. Moreover, firms have been very responsive to FINRA’s feedback resulting from exams by addressing deficiencies.

The Notice and the practices highlighted therein are envisioned by FINRA to be “positive steps in building a strong compliance environment.” FINRA encourages firms to carefully consider the practices discussed in the Notice in the near term to determine whether additional efforts are required to improve the suitability determination and supervision process, rather than wait for a regulatory examination that finds their practices to be wanting. To help firms adjust to the new rule, we will summarize FINRA’s findings and best practices.

Setting the stage: suitability rule requirements

Rule 2111, effective as of July 9, 2012, pulled together into one rule FINRA’s prior suitability rule together with case law established by FINRA and other policy-related enhancements. The rule imposes three suitability obligations:
1. **Reasonable-basis analysis** requires a firm or associated person to perform reasonable diligence to understand the nature of a recommended security or investment strategy involving a security, its potential risks and rewards, and determine whether a recommendation for investment in that security is suitable for any investors;

2. **Customer-specific analysis** requires a firm or associated person to have a reasonable basis to believe that an investment recommendation is suitable for a particular customer, based on the customer's investment profile; and

3. **Quantitative analysis** requires a firm or associated person with actual or de facto control over a customer account to have a reasonable basis to believe that a series of recommended transactions, even if individually suitable, are not excessive when viewed collectively.

The rule applies suitability determinations to explicit recommendations to “hold” a security and recommended investment strategies, in addition to recommendations to buy or sell a security. The rule adds new customer investment profile factors (age, investment experience, time horizon, liquidity needs and risk tolerance) to the previous list (other holdings, financial situation and needs, tax status and investment objectives) and provides an exemption to customer-specific suitability for recommendations to institutional customers if certain criteria are met.

**A glimpse behind the curtain: the mechanics of FINRA’s suitability examinations**

The Notice reveals that FINRA examiners start analyzing suitability rule compliance by analyzing a firm's controls, that is, its policies and procedures, in light of the products sold and customers served, and its readiness to control risks related to suitability. The depth and breadth of such testing is determined by the supervisory systems and controls already developed, the products and strategies recommended by the firm, its business activities and customer base and other relevant information.

Member firms should expect that examiners will seek suitability-related information on topics such as:

- training offered regarding suitability rule amendments, and investment strategy and hold recommendations;
- investment strategy definition and supervision;
- supervisory and compliance procedures for reasonable-basis, customer-specific and quantitative suitability;
- tools used to identify in-and-out trading and high turnover rates and commission-equity ratios;
- institutional account determinations; and
- determination of portfolio analytic tools or models’ compliance with the suitability rule or their qualification for a safe harbor.

After FINRA examiners obtain this information, they review firm controls to determine whether firm procedures are being followed, and may expand the scope of the examination to analyze material deviations between procedures and practices. Examiners may also review transactions and related suitability documentation when there are red flags raised as to potential unsuitable recommendations. Red-flag transactions could be those that: appear to deviate from the firm's internal suitability guidelines for a particular security; provide a long-term investment for an investor with a short-term horizon; constitute a speculative investment or strategy held in the account of an investor with a conservative investment objective; or indicate that the same security was held in the account or the same strategy was implemented for multiple investors of a particular representative despite differing customer profiles.
Plaudits and pans: findings from FINRA’s suitability examinations

While noting that the suitability rule was amended only recently, and that many firms have not been examined since those amendments became effective, the Notice concluded that most firms examined to date have updated policies, procedures and systems, trained staff and obtained additional customer investment profile information. At the same time, a small percentage of firms examined have not taken “a comprehensive approach to best ensure compliance with the rule.” The most frequent deficiency noted consisted of inadequate procedures for supervising and documenting hold recommendations. FINRA disposed of the vast majority of examinations with deficiencies through an informal Cautionary Action, while it referred a few examination findings involving suitability violations actionable under the predecessor suitability rule to FINRA’s Enforcement Department.

Practice makes perfect: effective practice observations

While acknowledging that there is no one-size-fits-all approach to compliance and supervision, the Notice highlighted some measures and practices that could bolster a firm’s suitability-focused supervisory and compliance procedures.

Reasonable-basis suitability analysis

FINRA found that many firms have implemented a new product vetting process in an effort to adhere to the rule’s reasonable-basis suitability review requirements. While observing that the new product vetting process alone does not satisfy the associated persons’ obligations to understand the securities and investment strategies recommended to customers, FINRA reported approvingly that some firms post to internal websites documents related to product due diligence, such as audited financial statements, notes of interviews with key product sponsor or issuer personnel and other information on the product and its features. Associated persons may consult these documents prior to making investment recommendations. Additionally, some firms require associated persons to complete instructor-led or online training prior to engaging in the sale of an approved product and may even require them to pass a test at the conclusion of the training.

Customer-specific suitability analysis

The Notice found that many firms began collecting additional information for new customers and supplementing existing customer investment profile information prior to the effective date of the amended rule by updating account forms and using electronic customer relationship management systems to capture this information. FINRA also found that firms made significant technological changes to internal systems to capture the added customer profile data. Some firms have even prohibited recommended transactions unless the customer fully completed or updated account information with all of the factors listed in the amended rule.

Firms have also implemented new policies and exception systems flagging vulnerable investors, such as those unable to sustain more than limited losses, individuals near or in retirement or other investors who rely on an income stream from an investment portfolio.

Quantitative suitability analysis

FINRA learned that to comply with the quantitative suitability provision of the rule, most firms had already been monitoring customer accounts for churning and excessive trading. Some firms upgraded their surveillance and monitoring systems, and exception reports, by integrating additional customer profile information. Going forward, FINRA recommended that firms evaluate their compensation arrangements to determine whether they incentivize a sales person to engage in unsuitable excessive trading, or to make unsuitable recommendations.
**The institutional-customer exemption**

While some firms with an institutional customer base use tailored account opening documents, others use separate forms or certifications to facilitate compliance with the institutional-customer exemption. In these documents, the institutional customer acknowledges in writing that it will exercise independent judgment in evaluating recommendations. Other firms obtain the affirmative indication through conversations with their institutional customers and then document those conversations. Yet other firms use third-party vendors to verify the institutional status and sophistication of customers.

**Hold and other investment strategy recommendations**

FINRA learned that the “hold” and “investment strategy” aspects of the suitability rule created behavioral and cultural challenges for firms, since it was not previously customary for registered representatives to consider an explicit hold as a recommendation or to document a strategy. Therefore, many firms provided initial and ongoing training on this aspect of the rule, while other firms were deficient in adapting to the new requirement.

FINRA acknowledged systems some firms adopted to achieve compliance with the hold and strategy requirements, including: a “hold ticket” or “hold blotter” capturing the hold and other types of strategy recommendations; notes of conversations with clients regarding explicit hold or other strategy recommendations, including the use by some small firms of clearing firm platforms to capture explicit hold recommendations or other strategies; branch office inspections focusing on the documentation of the hold and other strategy conversations with clients; revised new account forms that include specific investment strategies; new or amended account opening forms signed by the customer when the associated person recommends changes to a previous account investment strategy; and a prohibition on associated persons engaging firm clients in their outside business activities.

**Supervision and compliance**

FINRA examinations indicated that an effective and reasonable system of supervision and compliance over the areas covered by the suitability rule delineates who is responsible for conducting a specific review, what will be reviewed, the frequency of reviews and the documentation required to evidence the review. To detect potential red flags, some small firms look beyond an individual customer’s account, at concentrated positions of a security in the accounts serviced by specific registered representatives or across customer accounts or branch offices for an accumulation of a security that is not readily explained (e.g. a security not followed by the firm). These red flags may then become the subject of review by the firm.

**Conclusion**

The Notice provides a wealth of information on the types of approaches, systems, procedures and practices that member firms have been using and that FINRA has determined to be most effective in ensuring compliance with the suitability rule. Although other ways to comply with the rule certainly exist, member firms should review the Notice and consider incorporating the practices discussed or practices likely to achieve similar outcomes.

**Note**


**Corresponding author**

Daniel Nathan can be contacted at: dnathan@mofo.com

To purchase reprints of this article please e-mail: reprints@emeraldinsight.com
Or visit our web site for further details: www.emeraldinsight.com/reprints