

FINRA REMINDS FIRMS OF THEIR PRINCIPAL-PROTECTED NOTES SALES OBLIGATIONS

Regulatory Notice Stresses Fair and Balanced Promotional Materials, Suitability Duties

The Financial Industry Regulatory Industry (“FINRA”) recently issued a Regulatory Notice reminding member firms of their sales practice duties to ensure that promotional materials and public communications regarding principal-protected notes (“PPNs”) are fair, balanced, and do not overstate the level of protection offered or an investment’s potential returns. Firms are also reminded of their duty to ensure that registered representatives understand the products’ risks, terms, and costs and that they are required to perform adequate suitability analysis before recommending PPNs to a customer.

The full text of Regulatory Notice 09-73 (the “Notice”) is located at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120596.pdf>. The Notice should be read in conjunction with FINRA Notice to Members 05-59 which provides guidance to members concerning their obligations when selling structured products, including the requirements to: (1) provide balanced disclosure in promotional efforts; (2) ascertain accounts eligible to purchase structured products; (3) deal fairly with customers with regard to derivative products; (4) perform a reasonable-basis suitability determination; (5) perform a customer-specific suitability determination; (6) supervise and maintain a supervisory control system; and (7) train associated persons. Notice to Member 05-59 is located at <http://www.finra.org/Industry/Regulation/Notices/2005/P014997>.

PPNs

Investors have been attracted to PPNs in recent years largely because they offer the relative safety of bonds and the potential for growth from an underlying asset, something not typically available with traditional fixed income products. These securities are structured products that typically offer economic exposure similar to a combination of a zero-coupon bond with an option or other derivative linked to an underlying asset, index, or basket of assets or indices. PPNs thus guarantee the return of some or all principal at a set maturity date while also entitling the investor to participate in a return linked to a specified change in an underlying asset.

Despite these potential benefits, PPNs are not risk-free. Although many PPNs have been marketed using descriptions such as “principal protection,” “capital guarantee,” “absolute return,” “minimum return,” or some other variation of terms, they are complex products subject to a wide variety of risks. FINRA is concerned that the evolution of PPNs has resulted in complicated payout and guarantee

structures that make it difficult for many investors and brokers to accurately assess the risk and potential for gain. For example, while some PPNs guarantee 100% return of principal, others guarantee far less, and in most cases only if held to maturity.

Disclosure Obligations

NASD Rule 2210 requires that all communications with the public, including advertisements and public appearances, present a fair and balanced description of both risks and potential benefits. The rule also prohibits exaggerated, unwarranted, or misleading statements and the omission of any material fact or qualification that would cause the communication to be misleading. When marketing a product as offering principal protection, therefore, the Notice reminds firms that they must ensure that the operation of the securities is fairly explained. Promotional materials must contain appropriate disclosures concerning, among other things:

- the level of principal protection offered;
- the credit-worthiness of the guarantor;
- the potential returns and payout structure, including any limits on upside potential;
- the investor's ability to access funds pending maturity date or the expiration of a lock-up period, if any; and
- any costs or fees that might affect the return of principal.

In addition, the Notice provides that it would potentially violate Rule 2210 to omit from sales materials and oral presentations a description of the derivative component of a PPN and instead present such products as ordinary debt securities. Firms are reminded to fairly balance any statements concerning the fact that a product has a ticker symbol or has been approved for listing on an exchange with the risks that an active, liquid market may not develop or may cease to exist without warning. FINRA believes that such disclosure in a prospectus supplement would not cure an otherwise deficient communication, even if such sales material is accompanied or preceded by the prospectus supplement.

Training Obligations

The Notice reminds firms that they must train their registered representatives to understand the characteristics, risks, and rewards of each product before recommending the product to investors. PPN training should emphasize, among other things:

- the associated risks of such products, including the credit-worthiness of the guarantor;
- the terms and conditions, including the payout structure;
- the underlying index, asset, or benchmark;
- the potential for growth;
- the fee structure; and
- any other features that may impact the product's suitability, both generally and for a specific investor.

Suitability Obligations

NASD Rule 2310 requires that firms have a reasonable basis for determining that a product is suitable, both generally and for specific customers, by performing adequate due diligence. This requires careful review and understanding of the risks, costs, terms, and conditions of a product being offered. Before executing a recommended transaction, firms are required to make reasonable effort to obtain information about the investor's financial status, tax status, investment objectives, and other information used to make a recommendation. Before recommending PPNs, therefore, firms should consider and fully understand, among other things:

- the credit-worthiness of the guarantor in assessing the suitability of offering full or partial principal protection;
- the nature and terms of the principal guarantee;
- payout structure;
- costs and fees;
- the likelihood that the investor will need to access their money before the maturity date or expiration of the lock-up period, if any;
- the call risk associated with any callable notes;
- tax consequences; and
- the sacrifice of higher yields to obtain the principal guarantee, including consideration of the fact that the principal guarantee generally does not offer inflation protection.

In addition, because some PPNs offer a return component that is effectively similar to the exposure to an option, FINRA suggests that firms should consider (i) whether PPNs that guarantee only a portion of principal should be restricted to investors whose accounts have been approved for options trading; and (ii) whether it would be appropriate to apply options trading suitability requirements to PPNs. FINRA further suggests that firms that do not limit purchases of PPNs in this way should develop other procedures designed to ensure that PPNs are only sold to persons for whom the risk of such products is appropriate. These firms should be prepared to demonstrate the basis for allowing investors who have not been approved for options trading to purchase PPNs.

Finally, firms are reminded that NASD IM-2310-2(e) emphasizes firms' obligations to deal fairly with customers and make every effort to familiarize themselves with each customer's unique financial situation when making recommendations or accepting orders for new financial products, such as PPNs.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Corporate Finance and Securities Group or visit us online at chapman.com.

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