

Structured Notes Under Scrutiny: FINRA Notice to Members 09-73

January 12, 2010

During the turbulent financial markets over the last two years, structured notes marketed as principal protected have gained in popularity. PPNs are structured investment products that can be linked to a broad range of underlying investments, such as indexes, options on indexes, baskets of stocks, bonds or other assets. They often combine derivatives with equities and/or fixed income investments and guarantee a full or partial return of principal at maturity. PPNs aim to protect principal for investors who also seek potential gains in the underlying investments.

This growth in popularity of PPNs has raised concerns, however. In the past year, a number of lawsuits as well as arbitrations have been filed alleging misrepresentations made by brokerage firms in selling principal protected notes issued by Lehman Brothers, who defaulted under these notes upon its bankruptcy filing in September 2008.

In order to address these concerns, the Financial Industry Regulatory Authority ("FINRA") recently issued Notice to Members 09-73 (the "2009 Notice") reminding member firms of their sales practice obligations in marketing and selling PPNs to investors. The 2009 Notice reiterates the requirements of member firms to provide balanced materials to the public relating to the risks and returns associated with principal protected notes, to determine the suitability of such notes for an investor and to train registered persons in making recommendations of the notes to appropriate investors.

The 2009 Notice

The 2009 Notice builds upon a prior NASD (the predecessor of FINRA) notice, Notice to Members 05-59 (the "2005 Notice") which provided guidance to members concerning the sale of structured products in general. The 2005 Notice reminded members to do the following when selling structured products:

- (a) Provide balanced disclosure in promotional efforts;
- (b) Ascertain accounts eligible to purchase structured products;
- (c) Deal fairly with customers with regard to derivative products;
- (d) Perform a reasonable-basis suitability determination;
- (e) Perform a customer-specific suitability determination;

- (f) Supervise and maintain a supervisory control system; and
- (g) Train associated persons.

While there is some overlap between the guidance provided in the 2005 Notice and the 2009 Notice, the 2009 Notice focuses specifically on the risks involved when a structured product is marketed and sold as a "principal protected" product. The 2009 Notice begins by noting that PPNs are often marketed as combining the relative safety of bonds with a potential for growth that is not available in typical fixed income products. These products are not risk-free, however, and FINRA notes that broker-dealers must ensure that their promotional materials are fair and balanced and do not overstate the level of protection or the potential returns. These structures are often complex and member firms must therefore ensure that investors are not misled by the reassuring names of the notes and are provided with full disclosure of the complexities of such notes. FINRA recommends appropriate disclosures concerning:

- (i) The level of principal protection offered;
- (ii) The creditworthiness of the guarantor;
- (iii) The potential returns and pay-out structure (including any limits on upside potential);
- (iv) The investor's ability to access funds pending maturity date or the expiration of a lock-up period; and
- (v) Any costs or fees that might affect the return of principal.

The 2009 Notice, like the 2005 Notice, advises firms that PPN disclosure should include a description of the derivative component of the product and the risks that an active and liquid trading market may not develop. Also, as in the 2005 Notice, firms are reminded that providing risk disclosure in a prospectus supplement does not cure otherwise deficient disclosure in sales material and oral presentations, even if such sales material is accompanied or preceded by the prospectus supplement.

Going beyond the 2005 Notice, however, the 2009 Notice focuses specifically on the risk of the creditworthiness of the guarantor, identifying this risk as one of the most important risks that should be disclosed. This risk was not mentioned in the 2005 Notice and its emphasis in the later 2009 Notice is not surprising given the bankruptcy and failures of a number of issuers of PPNs, including Lehman since the 2005 Notice was issued. Given its focus on PPNs, rather than structured products in general, the 2009 Notice, unlike the 2005 Notice, requires firms to highlight the level of principal protection that is offered.

Like the 2005 Notice, the 2009 Notice also reminds member firms of their obligations to determine the suitability of PPNs, both generally and for specific investors. The 2009 Notice states that pursuant to NASD Rule

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

Pursuant to US Treasury Department Circular 230, unless we expressly state otherwise, any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties or (ii) promoting, marketing or recommending to another party any matter(s) addressed herein.

No part of this publication may be reproduced, in whole or in part, in any form, without our prior written consent.

© 2009 Dewey & LeBoeuf LLP
All rights reserved.

For further information on Dewey & LeBoeuf, please visit www.dl.com

2310, “before recommending the purchase or sale of a security, firms must have a reasonable basis for determining that the product is suitable for at least some investors. To make this determination, firms must perform adequate due diligence, which includes carefully reviewing and understanding the risks, costs, terms and conditions of the product being offered.” In assessing suitability for a particular investor, FINRA reminds member firms to consider, among other things:

- (i) The investor’s financial status, tax status and investment objectives;
- (ii) The nature and terms of the principal guarantee, as well as the note’s pay-out structure, costs and fees; and
- (iii) Tax consequences that can affect whether the notes are suitable for a specific investor.

The 2009 Notice emphasizes certain additional factors beyond those in the 2005 Notice that firms should consider before recommending a PPN, such as the investment’s costs and fees, whether the investment is designed to be held to maturity and if so, the likelihood that the customer may need to access his or her funds before the maturity date and the call risk associated with any callable notes. Suitability considerations regarding tax consequences also receive more attention in the 2009 notice, in particular, the fact that investors may have to pay US income tax yearly on the imputed interest on certain zero coupon bonds even if no actual cash distributions are paid into the account from the bonds unless held in a tax-deferred retirement account.

Lastly, the 2009 Notice requires member firms to train registered persons in making suitable recommendations of investment products to investors. Registered persons must understand the structure of each note and the factors that would make such note suitable for specific investors. The training should highlight:

- (i) The risks associated with such notes, including the credit-worthiness of the guarantor;
- (ii) The terms and conditions, including the pay-out structure;
- (iii) The underlying index, asset or benchmark;
- (iv) The investment’s potential for growth;
- (v) The fee structure; and
- (vi) Any other features that might impact the note’s suitability, both generally and for a specific investor.

For more information, please contact Eileen Bannon at + 1 212 259 6190 or ebannon@dl.com; Evan M. Koster at + 1 212 259 6730 or ekoster@dl.com; Prachi Shah at + 1 212 259 7146 or pshah@dl.com; or your Dewey & LeBoeuf relationship partner.