

# FINRA Files Amended Communications Rules

## Impact on Structured Products

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On July 14, 2011, the Financial Industry Regulatory Authority, Inc. filed with the Securities and Exchange Commission a proposal to adopt various rules in the Consolidated FINRA Rulebook affecting members' communications with retail and institutional investors, as well as with internal sales forces, and these amendments will likely affect the offer and sale of structured products in several important ways.<sup>1</sup> A separate Davis Polk Newsflash, [available here](#), more generally analyzes how the proposed changes will impact broker-dealers.

### Key issues

The proposal raises the following key issues:

- *Reorganization of existing communication categories.* The amendments would reduce the number of current communication categories from six (advertisements, sales literature, correspondence, institutional sales material, independently prepared reprints and public appearances) to three (retail communications, institutional communications and correspondence).

The attached charts set out the new communication categories and the FINRA requirements that would apply to each category.

- *Post-use filing requirement for certain retail structured product communications.* Subject to the exceptions described below, the rules would require “[r]etail communications<sup>2</sup> concerning any security that is registered under the Securities Act and that is derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency” to be filed with FINRA within 10 business days after first use or publication. FINRA cautions that it does not want to constrain the proposed rule to an enumerated list of structured products due to continual product innovation and so FINRA may broadly interpret this definition of structured products and may take the position that securities commonly considered to be structured products would fall within the proposed rule.<sup>3</sup> Nonetheless, retail communications relating to an instrument that is not a security, such as a market-linked certificate of deposit, or relating to a security that is not registered under the Securities Act, such as a security exempt from registration under Section 3(a)(2) of the Securities Act, would not be subject to the filing

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<sup>1</sup> Please refer to <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p123893.pdf>. The rules were initially proposed for amendment in 2009 through Regulatory Notice 09-55.

A copy of Davis Polk's client memorandum regarding Regulatory Notice 09-55 is accessible [here](#).

<sup>2</sup> “Retail communication” would mean any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period.

<sup>3</sup> The relevant section of the proposed rule change states that FINRA “does not believe it is appropriate to attempt to list all products that are derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency. Members frequently develop new types of retail structured products that would not be included in any list that FINRA created today. Thus, FINRA believes that it is better to leave open the possibility that retail communications concerning new products also will fall under this filing requirement”.

requirement. In contrast to the proposal contained in FINRA's Regulatory Notice 09-55, "pre-filing" of communications (i.e. filing prior to use) would not be required under the proposed rule.

- *Most prospectuses and similar documents exempt from filing.* FINRA explicitly exempts prospectuses and free writing prospectuses ("**FWPs**") from the filing requirement, other than "broadly disseminated" FWPs (as discussed below).
- *Broadly disseminated free writing prospectuses must be filed.* Similar to the guidance contained in FINRA's Regulatory Notice 10-52,<sup>4</sup> FINRA would require FWPs filed with the SEC pursuant to Securities Act Rule 433(d)(1)(ii) ("broadly disseminated FWPs")<sup>5</sup> to be filed with FINRA within 10 business days of first use or publication. These FWPs would also need to comply with the content and principal review requirements applicable to retail communications in Rule 2210. FINRA states that "such [broadly disseminated FWPs] must be filed with FINRA to the extent that they constitute a retail communication covered by another filing requirement (such as a free writing prospectus concerning a structured product registered under the Securities Act)".
- *FINRA did not explicitly reconfirm its earlier position that the content and principal review requirements do not apply to prospectuses and FWPs (other than broadly disseminated FWPs).* In 2006, FINRA published an interpretive letter<sup>6</sup> in the wake of the SEC's securities offering reform that defined and established the rules governing the use of FWPs in which it reconfirmed longstanding FINRA policy that issuer-created documents, such as prospectuses, were excluded from the provisions of NASD Rules 2210 and 2211 and stated that all FWPs were also exempt from those rules. Subsequently, in 2010, FINRA published Regulatory Notice 10-52, which withdrew, in part, that guidance by subjecting FWPs distributed by a broker-dealer in a manner reasonably designed to lead to broad unrestricted dissemination to NASD Rules 2210 and 2211, including the content standards, the principal review requirements and applicable filing requirements.

While the proposed rule change is clear that prospectuses and FWPs (other than broadly disseminated FWPs) are exempt from the filing requirements, it does not reconfirm the 2006 guidance that such documents would also be exempt from the principal review and content requirements. Since the proposed rule change subjects each retail communication to the principal review and content requirements (not just retail communications concerning structured products), then each prospectus and FWP that falls within the definition of retail communications could, in theory, become subject to these requirements if the proposal is approved by the SEC.<sup>7</sup>

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<sup>4</sup> A copy is accessible [here](#).

<sup>5</sup> Securities Act Rule 433(d)(1)(ii) requires that any offering participant, other than the issuer, shall file any free writing prospectus that is used or referred to by such offering participant and distributed by or on behalf of such person in a manner reasonably designed to lead to its broad unrestricted dissemination. In Regulatory Notice 10-52, FINRA noted that the SEC has provided guidance concerning the meaning of the term "broad unrestricted dissemination" and FINRA explicitly incorporates that guidance. Examples of broad unrestricted dissemination of a free writing prospectus by a broker-dealer would include posting such prospectus on an unrestricted website or releasing it to the media. A broker-dealer does not make a broad unrestricted dissemination if a free writing prospectus is posted to a restricted website or sent directly to its customers, regardless of the number of customers. See Regulatory Notice 10-52 on page 3 citing Securities Exchange Act Release No. 52056 (July 19, 2005), 70 FR 44722 (August 3, 2005) (Order Approving SEC File No. S7-38-04, Securities Offering Reform).

<sup>6</sup> A copy is accessible [here](#).

<sup>7</sup> The existing rule subjects advertisements and sales literature to the principal review and content requirements and the definition of these two categories of sales materials does not include prospectuses or FWPs. The new rule would largely replace those categories with a new definition of retail communication, and nothing in the new rule specifically exempts prospectuses or FWPs from the principal review or content requirements, in contrast to the explicit exemption from the filing requirements.

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If intended, this could mean significant additional compliance burdens on distributors of structured products. We think the better view is that FINRA did not intend such an interpretative change as it likely would have telegraphed it in the proposal. Nonetheless, participants in the structured products market may consider whether to seek clarification from FINRA that no change was intended.

- *Internal-use only communications.* Significantly, a member's internal written (including electronic) communications that are intended to educate or train registered persons about the products or services offered by a member, which include sales force memos, would now be considered institutional communications and would be subject to the content and principal review requirements of FINRA Rule 2210. This is a change from current requirements and reflects FINRA's focus on the training and supervision of sales forces that has been a theme in recent enforcement actions related to structured products.
- *Spot-check and record-keeping requirements.* The provisions governing spot-check and record-keeping would generally mirror current requirements. See the second chart below for further information.

## Timing and implementation

The SEC seeks comments on the amendments by August 24, 2011.

The SEC will approve or disapprove the proposed rule change, or institute proceedings to determine whether the proposed amendments should be disapproved, by September 17, 2011, subject to certain extension provisions.

If approved by the SEC, FINRA states that it will announce the implementation date of the amendments no later than 90 days following SEC approval, and that the implementation date will be no later than 365 days following such approval.

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Advertisements are currently defined as "Any material, other than an independently prepared reprint and institutional sales material, that is published, or used in any electronic or other public media, including any Web site, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, or telephone directories (other than routine listings)."

Sales literature is currently defined as "Any written or electronic communication, other than an advertisement, independently prepared reprint, institutional sales material and correspondence, that is generally distributed or made generally available to customers or the public, including circulars, research reports, market letters, performance reports or summaries, form letters, telemarketing scripts, seminar texts, reprints (that are not independently prepared reprints) or excerpts of any other advertisement, sales literature or published article, and press releases concerning a member's products or services."

## Communication categories

The proposed rule change would reduce the number of current communication categories from six to three, as follows:

Type of communication	Definition and commentary based on the proposed rule change
<b>Retail communications</b>	<ul style="list-style-type: none"> <li>▪ Any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period.<sup>8</sup></li> <li>▪ “Retail investor” would mean any person other than an institutional investor, regardless of whether the person has an account with the member.</li> </ul>
<b>Institutional communications</b>	<ul style="list-style-type: none"> <li>▪ Any written (including electronic) communication that is distributed or made available only to institutional investors.<sup>9</sup></li> <li>▪ A member’s internal written (including electronic) communications that are intended to educate or train registered persons about the products or services offered by a member would be considered institutional communications.<sup>10</sup></li> <li>▪ No member may treat a communication as having been distributed to an institutional investor if the member has reason to believe that the communication or any excerpt thereof will be forwarded or made available to any retail investor.</li> </ul>
<b>Correspondence</b>	<ul style="list-style-type: none"> <li>▪ Any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30 calendar-day period.</li> </ul>

<sup>8</sup> Communications that currently qualify as advertisements and sales literature generally would fall under the definition of “retail communication.” In addition, to the extent that a member distributed or made available a communication that currently qualifies as an independently prepared reprint to more than 25 retail investors within a 30 calendar-day period, the communication also would fall under the definition of “retail communication.” Communications that currently qualify as “institutional sales material” would fall within the definition of “institutional communication.” Some communications that currently qualify as “correspondence” would continue to fall within that definition. However, communications sent to more than 25 retail investors within a 30 calendar-day period in all cases would be considered retail communications.

<sup>9</sup> This definition would include communications that fall within the current definition of “institutional sales material” under NASD Rule 2211(a)(2): written (including electronic) communications that are distributed or made available only to institutional investors. “Institutional investor” generally would have the same definition as under NASD Rule 2211(a)(3). FINRA has modified the definition of “institutional investor” in proposed FINRA Rule 2210 to clarify that the term includes multiple employee benefit plans and multiple qualified plans offered to employees of the same employer, provided that the plans in the aggregate have at least 100 participants.

<sup>10</sup> Accordingly, such internal communications are subject to both the provisions of proposed FINRA Rule 2210 and NASD Rule 3010(d) (Review of Transactions and Correspondence, which governs the supervision and review of written correspondence).

Summary of requirements applicable to structured products

Type of communication	Filing	Principal review	Content standards	Spot-check/record-keeping
<p><b>Retail communications</b></p>	<ul style="list-style-type: none"> <li>▪ Included among the types of communications members must file within 10 business days of first use are retail communications concerning any security that is: (i) registered under the Securities Act; and (ii) that is derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency. <i>This is a change from the current rules.</i></li> <li>▪ The proposed rule retains the existing exclusion from the filing requirements for prospectuses and similar documents that have been filed with the SEC. However, a free writing prospectus that has been filed with the SEC pursuant to Securities Act Rule 433(d)(1)(ii) (a broadly disseminated free writing prospectus) would be required to be filed within 10 days of first use or publication).<sup>11</sup></li> </ul>	<ul style="list-style-type: none"> <li>▪ The proposed rule change would require an “appropriately qualified” registered principal of the FINRA member to approve each retail communication before the earlier of its use or filing with FINRA.<sup>12</sup> <i>This is a change from the current rules.</i></li> <li>▪ Note that retail communications that do not make any financial or investment recommendation or otherwise promote a product or service of the member (i.e. non-promotional communications) would not be subject to the proposed principal approval requirements.</li> </ul>	<ul style="list-style-type: none"> <li>▪ The proposed rule change largely incorporates the current content standards applicable to communications with the public that are found in the current rules.<sup>13</sup> However, content standards that currently apply to advertisements and sales literature generally would apply to the more broadly-defined category of retail communications. <i>This is a change from the current rules.</i></li> <li>▪ See the discussion above in the fifth bullet regarding the absence of FINRA confirmation that prospectuses and FWPs (other than broadly disseminated FWPs) would not be subject to the content standards.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Retail communications are subject to possible spot-check procedures. <i>This is consistent with the current rules. In addition, under the existing rules, the universe of materials subject to FINRA spot-checks are the materials that members have to keep pursuant to the record-keeping requirements.</i></li> <li>▪ The record-keeping requirements for retail and institutional communications generally would mirror current record-keeping requirements. The relevant proposed provision would incorporate by reference the record-keeping format, medium and retention period requirements of Securities Exchange Act Rule 17a-4.</li> </ul>

<sup>11</sup> Regulatory Notice 10-52 stated that broadly disseminated FWPs were subject to applicable filing requirements; the proposed rule change states that any free writing prospectus that has been filed by an offering participant with the SEC pursuant to Securities Act Rule 433(d)(1)(ii) must be filed.

Type of communication	Filing	Principal review	Content standards	Spot-check/record-keeping
	<ul style="list-style-type: none"> <li>▪ The proposed rule change largely maintains the other existing exclusions from the filing requirements.</li> <li>▪ Retail communications that are based on templates that were previously filed with FINRA the changes to which are limited to updates of more recent statistical or other non-narrative information would also be excluded from the filing requirements. <i>FINRA states that this exclusion is based in part on an earlier staff interpretation concerning how NASD Rule 2210's approval, record-keeping and filing requirements apply to statistical updates contained in pre-existing templates.</i></li> </ul>	<ul style="list-style-type: none"> <li>▪ See the discussion above in the fifth bullet regarding the absence of FINRA confirmation that prospectuses and FWPs (other than broadly disseminated FWPs) would not be subject to the principal review requirements.</li> </ul>		

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<sup>12</sup> This can be contrasted with the position under the current rules, which apply this principal review requirement to advertisements, items of sales literature and independently prepared reviews. The new requirements are subject to some limited exceptions (which relate to certain retail communications excepted from the definition of “research report” pursuant to NASD Rule 2711(a)(9)(A), retail communications posted on an online interactive electronic forum and retail communications that do not make any financial or investment recommendation or otherwise promote a product or service of the member), and a provision allowing FINRA to grant an exemption from the pre-use principal approval requirement for “good cause shown”.

<sup>13</sup> Proposed FINRA Rules 2210(d)(1)(D) and (E), which would require, in summary, that members ensure that statements are clear and not misleading within the context in which they are made, provide balanced treatment of risks and potential benefits, consider the nature of the audience to which the communication will be directed and provide details and explanations appropriate to the audience generally incorporate standards found in the current rules.

Type of communication	Filing	Principal review	Content standards	Spot-check/record-keeping
<p><b>Institutional communications</b></p>	<ul style="list-style-type: none"> <li>Not required except that if FINRA determines that a member has departed from the standards of Rule 2210, it may require that such member file “all communications”, or the portion of such member’s communications that is related to any specific type or classes of securities or services at least 10 days prior to first use. <i>This exception is a change as the current rule only requires the pre-filing of advertisements and sales literature if the member has departed from the standards of Rule 2210. All such filings would be subject to principal review.</i></li> </ul>	<ul style="list-style-type: none"> <li>The proposed rule change generally would maintain the supervision and review standards for correspondence and institutional communications that are currently found in NASD Rules 2211 and 3010(d): Rule 2210 would explicitly require that each member establish written procedures that are appropriate to its business, size, structure, and customers for the review by an appropriately qualified registered principal of institutional communications used by the member and its associated persons. <i>This is generally consistent with the current rules.</i></li> </ul>	<ul style="list-style-type: none"> <li>Importantly, the proposed rule change would require institutional communications, which would include certain internal communications such as sales force memos,<sup>14</sup> to comply with the “fair and balanced” content requirements of Rule 2210. <i>The inclusion of certain types of internal communications in the definition of institutional communication is a change from the current rules.</i></li> </ul>	<ul style="list-style-type: none"> <li>Institutional communications are subject to possible spot-check procedures. This is consistent with the current rule. Note that under the current rules, FINRA may already spot check non-public communications.</li> <li>See above with respect to recordkeeping.</li> </ul>

<sup>14</sup> A member’s internal written (including electronic) communications that are intended to educate or train registered persons about the products or services offered by a member.

Type of communication	Filing	Principal review	Content standards	Spot-check/record-keeping
<p><b>Correspondence</b></p>	<ul style="list-style-type: none"> <li>▪ Not required subject to the same potential exception noted above with respect to institutional communications.</li> </ul>	<ul style="list-style-type: none"> <li>▪ The proposed rule change generally would maintain the supervision and review standards for correspondence and institutional communications that are currently found in NASD Rules 2211 and 3010(d).</li> </ul>	<ul style="list-style-type: none"> <li>▪ Correspondence would be required to comply with the “fair and balanced” content requirements of Rule 2210. <i>This is consistent with the current rules.</i></li> <li>▪ Note that some standards previously only applicable to more narrowly defined categories of communication would be extended to cover correspondence (see, for example, the requirements regarding tax considerations and testimonials).</li> </ul>	<ul style="list-style-type: none"> <li>▪ Correspondence is subject to possible spot-check procedures. This is consistent with the current rule.</li> </ul>

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