Morrison & Foerster News Bulletin Volume 2, Issue 4 April 14, 2011

Structured Thoughts

News for the financial services community.

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FINRA's "Principal Protected" Consent Agreement with UBS: Lessons and Reminders for the Structured Products Industry

Introduction

On April 11, 2011, the Financial Industry Regulatory Authority ("FINRA") announced that it had fined UBS Financial Services, Inc. ("UBS") $2.5 million, and required UBS to pay $8.25 million in restitution to investors. These penalties arise from alleged misleading statements and omissions in connection with offerings of so-called "principal protected notes" (PPNs).[1] These notes were issued by Lehman Brothers and underwritten by UBS prior to Lehman's September 2008 bankruptcy filing.[2]

These actions represent an additional step in the widely covered proceedings relating to these sales. These offerings, and Lehman's subsequent bankruptcy, have also resulted in class-action litigation against UBS and substantial (and mostly negative) coverage in the mainstream media.

[1] A copy of FINRA's press release may be found at: http://www.finra.org/Newsroom/NewsReleases/2011/P123479.

[2] With some hesitation, we use the term "principal protected note" in this article, solely for the convenience of the reader who works in this industry. In light of concerns expressed by the SEC, and criticisms raised in the mainstream media, we recommend that industry participants use these terms with caution (and appropriate qualification) when interacting with investors.

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Prior to FINRA's announcement, FINRA entered into a Letter of Acceptance, Waiver and Consent with UBS (the "Consent Agreement").[3] The Consent Agreement sets forth the factors that led FINRA to impose these penalties. Many of the activities and types of disclosures described in the Consent Agreement were not unique to UBS during the relevant period, and many institutions have already revised a variety of their practices in recent years to address the criticisms that have been previously raised as to the offerings described in the Consent Agreement. However, the Consent Agreement provides important insights and reminders as to the types of issues that are important to FINRA in connection with sales of structured products, and we discuss them here.

1. Offering Documents Must Not Provide Misleading Information About the Nature of Principal Protection

As widely reported, many of the written offering materials at issue used terms such as "100% Principal Protection," without necessarily clearly indicating the credit risk embedded in these instruments.[4] Accordingly, the Consent Agreement reminds broker-dealers that proper disclosure should make it clear (where applicable) that:

- A structured product represents an unsecured debt obligation of the relevant issuer.
- A structured product is not guaranteed by the government, the underwriter or any other entity.
- An investor in a structured product faces the risk of not receiving any payment on its investment if the relevant issuer files for bankruptcy, or is otherwise unable to pay its debts.

The relevant disclosure of the risk must appear in an appropriate place in the offering document to ensure that it is properly emphasized to an investor. A repeated theme in the Consent Agreement is that a general risk factor at the end of the offering document may not be sufficient to address a risk that should be addressed in the proper context.

Oral communications with investors should also be clear as to these points, and financial advisors should be trained and supervised to ensure that their characterizations of these instruments is proper.

2. FINRA's Review of Marketing Materials Is Not Limited to Statutory Prospectuses

FINRA's critiques of the relevant offering documents were not limited to the red herring and final pricing supplement, where a working group will often devote the bulk of its drafting efforts. Instead, FINRA's criticisms included other marketing materials that were furnished to investors. For example, FINRA's criticisms extended to a monthly client strategies guide, used to summarize the terms of the relevant product offerings to be made in a given month. FINRA also found inadequacies in several types of "internal-use-only" documents maintained for members of the sales force, which would increase the possibility that PPNs could be sold improperly.

Accordingly, to the extent that a broker-dealer creates and uses a variety of documents in connection with the offering process, these documents will also need to be scrutinized to ensure that they properly characterize the relevant risks.

[3] The Consent Agreement may be found at: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p123478.pdf.

[4] See page 5 of the Consent Agreement ("educational and marketing materials *may* have been confusing with respect to the characteristics and risks…" and "the aforementioned inadequacies in [UBS's] educational and marketing material *may* have resulted in some FA's misunderstandings of the product…") (emphasis added). At some level, it is possible that these materials may arguably have conveyed the credit risks, particularly when read together with the other offering documents provided to investors. See, for example, the related arguments advanced in Defendants' Reply Memorandum of Law, filed July 13, 2010 (pages 15-16); Defendants' Joint Memorandum of Law in Support of Their Motion to Dismiss the Third Amended Class Action Complaint (pages 26-31); and Defendants' Joint Reply Memorandum of Law in Further Supports of their Motion to Dismiss Plaintiffs' Securities Act Claims, filed July 31, 2009 (pages 41-47), Lehman Brothers Securities and ERISA Litigation, Civil Action 09 MD 2017, United States District Court for the Southern District of New York. However, in FINRA's view, these disclosures, as set forth in the relevant documents, were not adequate.

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3. Sales of All Structured Products Must Be Vetted for Suitability, Even If They Are "Principal Protected"

FINRA critiqued UBS for not maintaining risk profile requirements for customers who purchased PPNs linked to broad-based equity indices. As a result, investors who had a "conservative" risk profile were permitted to invest in these instruments without restriction.

Of course, many investors with a "conservative" risk profile invest a portion of their portfolio in some combination of bonds and equities, and structured products often represent a hybrid of a bond investment and an equity investment. Accordingly, in many cases, an investment in a structured product will be consistent with even a conservative investor's risk tolerance. What remains important is ensuring that all retail investors, particularly those that do not have an "aggressive" risk profile, are duly informed about the credit and other risks that are embedded in structured products, and that an investment in a product is consistent with their risk tolerance and portfolio allocation.[5]

4. Broker-Dealers Must Adequately Update Prospective Investors as to Material Changes in the Credit Profiles of the Issuers of Structured Products

Lehman's financial position eroded during 2008, and UBS and the general public were aware of these developments. FINRA determined that these facts were not adequately conveyed to UBS's sales force, and therefore, to investors. Internal and customer-directed marketing materials were not updated to reflect the changes to Lehman's credit risk.[6] In fact, while the economic terms of notes issued by Lehman were improving (in order to compensate investors for taking on Lehman's credit risk), investors were not receiving adequate disclosure to explain the nature of the credit risk that they were assuming. This compounded the risk that investors would purchase these instruments without properly understanding the relevant risks.

In recent years, a variety of underwriters have developed an "open architecture" or similar platform that enables them to offer the structured products of multiple issuers. These underwriters will need to ensure that they are adequately monitoring and communicating to investors the different identities of the applicable issuers, particularly in evaluating their different risk and credit profiles, as well as any changes to those credit risks.

5. A Broker's Sales Representatives Must Be Adequately Supervised and Trained in Connection with Sales of Structured Products

In the Consent Agreement, FINRA emphasizes the importance of appropriate training for sales represenatives. FINRA critiqued UBS for maintaining training programs for its sales force in structured products, but not initially requiring participation in those programs as a condition to selling structured products. As a result, FINRA notes in the Consent Agreement with some detail a number of key misunderstandings that a variety of FAs had concerning the structure and terms of PPNs. These misunderstandings substantially increased the possibility that these investments could be mis-sold.

In addition, the alleged inadequacies in the offering and marketing documents described above led FINRA to conclude that UBS's policies and procedures were inadequate to ensure that its sales force would adequately describe the Lehman PPNs and their risks to investors. The failure to restrict sales of these instruments to customers with a conservative or moderate risk profile, without sufficient protections, resulted in a finding that the relevant policies and procedures relating to sales practices were inadequate.

[5] We note that under FINRA's new suitability requirements, suitability will be evaluated both in terms of a specific investment, as well as a strategy as a whole. See related article in this issue, "FINRA Delays Effective Date for New Suitability and Know-Your-Customer Rules."

[6] For example, in the case of a typical equity-linked structured product, an issuer with a lower credit rating may need to offer investors a higher "participation rate" or "leverage factor," and/or a higher maximum return on the investment.

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Conclusion

The Consent Agreement represents one of FINRA's most significant responses yet to the criticisms that have been raised with respect to PPNs and other types of structured products. Many industry participants have been recently updating their disclosures, practices and procedures to address these concerns. However, in light of the publication of the Consent Agreement, and the insight it provides into FINRA's concerns, now is a useful time for broker-dealers to reassess their sales process, and to ensure proper compliance with proper offering practices.

FINRA Delays Effective Date for New Suitability and Know-Your-Customer Rules

On April 7, 2011, FINRA filed with the SEC[7] a proposed rule change to delay the implementation date for FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability). FINRA is proposing to move the implementation date of FINRA Rule 2090 and FINRA Rule 2111 from October 7, 2011 to July 9, 2012.

We previously described the provisions of FINRA Rule 2090 and Rule 211 in Volume 1, Issue 13 of *Structured Thoughts:* http://www.mofo.com/files/Uploads/Images/101004-Structured-Thoughts-Issue-13.pdf, as well as FINRA's announcement of the effective date of the rules in Volume 2, Issue 1 of *Structured Thoughts:* http://www.mofo.com/files/Uploads/Images/110120-Structured-Thoughts.pdf.

In November 2010, the SEC granted its approval to adopt FINRA Rule 2090 and FINRA Rule 2111. On January 10, 2011, FINRA issued *Regulatory Notice* 11-02, which outlined the new rules and set forth an implementation date of October 7, 2011. However, subsequent to the approval and publication, a number of firms requested a delay in the implementation date, arguing that more time was needed to:

- determine the types of systems and procedural changes needed;
- implement the rule changes; and
- educate associated persons and supervisors regarding compliance with the rules.

According to its SEC filing,[8] FINRA views the rule change as consistent with the provisions of Section 15A(b)(6) of the Securities Exchange Act of 1934. Under Section 15A(b)(6), rules by registered securities associations, such as FINRA, must be "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade…and, in general, to protect investors and the public interest." By delaying the implementation date, FINRA believes that firms will be in a better position to comply with the requirements of the new rules, without imposing a burden on competition.

The SEC is inviting interested person's to solicit comments in either an electronic or paper format. A copy of the SEC release regarding the newly proposed FINRA rule change, as well as instructions on submitting comments, may be found at: http://www.sec.gov/rules/sro/finra/2011/34-64260.pdf.

[7] See "Proposed Rule Change to Delay the Implementation date of FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability)" available at http://www.finra.org/Industry/Regulation/RuleFilings/2011/P123453.
[8] *Id.*

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