Client Alert

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Please Mr. Postman: FINRA Cracks Down on Late Prospectus Delivery

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FINRA has been engaged in a "stealth sweep" of firms' untimely deliveries of mutual fund and ETF prospectuses that has resulted in formal disciplinary proceedings against twelve firms since 2011, and a total of over $5 million in fines. Oddly, FINRA has not posted the "Targeted Examination Letter" that initiated the sweep, has not issued any guidance about the sweep's findings beyond the press release that announced the first of the eight disciplinary proceedings, nor done anything else to publicize the results and lessons of this initiative to the broker-dealer community.

So we will do it for them.

THE STATUTORY OBLIGATION

Section 5(b)(2) of the Securities Act of 1933 requires an issuer to deliver a physical copy of a prospectus before completing the sale of a security. Rule 15c6-1 effectively requires issuers to deliver the prospectus within three business days of the trade date.

Failure to comply with the prospectus delivery rule can mean violations of several additional rules. For example, the failure to establish systems and procedures reasonably designed to achieve compliance with securities laws, like 5(b)(2), violates NASD Conduct Rules 3010(a)(1) and (b)(1). In addition, FINRA Rule 2010 requires members to observe high standards of commercial honor and just and equitable principles in trade. FINRA can use each of these rules against a firm failing to provide prospectuses on time.

Section 5(b)(2)'s requirement of timely prospectus delivery also applies to the delivery of ETF prospectuses. In addition, the failure to deliver an ETF prospectus is a violation of NASDAQ Rule 5705, which governs broker-dealer sales of ETFs, and FINRA's business conduct rule.

FINRA'S ENFORCEMENT ACTIONS

In the past few months, FINRA has fined six large securities firms in addition to the two named in 2011 for their failures to provide new customers with a timely mutual fund prospectus as required by the Securities Act. Fines in the eight cases ranged from $40,000 to $1,000,000 for failures to provide prospectuses on time and to establish policies to monitor and ensure timely delivery. FINRA found that each firm had delivered between 2,500 and 934,074 prospectuses late for review periods of between one year and two and a half years. For some firms, this represented close to 5% of the prospectuses due during the relevant review period. FINRA cited one extreme example of a firm's delivery of a prospectus 410 days late.

In related cases, FINRA and NASDAQ's Department of Enforcement – with FINRA's support – also fined four firms a total of almost $3 million for their failures to deliver, or to deliver timely, exchange-traded fund (ETF) prospectuses.

COMMON CAUSES OF VIOLATIONS

In its Section 5(b)(2) cases, FINRA found deficiencies both in firms using third-party service providers to deliver the prospectuses and firms that deliver the prospectuses using their own representatives.

Broker-dealers typically contract with third-party service providers to mail the prospectuses to new customers. The firms cited by FINRA failed to supply the service provider with enough copies of their prospectuses to ensure that there was always a copy available to mail when needed. Those firms also failed to take advantage of the service provider's print-on-demand service, pursuant to which the service provider can print a copy of a prospectus when there is no copy available.

FINRA also cited the failure to adequately obtain and review reports from the service provider regarding the timeliness of prospectus delivery and a failure to respond to the deficiencies highlighted in those reports, as evidence that the firms were not fulfilling their obligation to establish a system that would ensure timely prospectus delivery. Most of the firms censured for violating Section 5(b)(2) received cumulative reports indicating that all of the prospectuses had not been delivered, but the firms did not ensure those prospectuses were delivered as soon as possible or change their policies to prevent future late deliveries. For the firms failing to provide ETF prospectuses, FINRA placed blame on the firms' failures to review daily and monthly reports indicating that customers were not receiving their prospectuses.

In addition, FINRA found that the two firms that relied on their own representatives to provide the prospectuses did not do enough to monitor and ensure that every prospectus was being delivered. One of the firms monitored the delivery of a prospectus by asking the customer in an annual survey whether it had been delivered. The other firm had a system that required the customer to sign for the prospectus upon delivery of the security, but did not have a system to effectively audit that process.

THE LESSONS OF FINRA'S SWEEP

It is likely that FINRA will continue to examine member firms' compliance with their prospectus delivery obligations, and firms should use the lessons of these cases to review their systems. Regardless of whether a firm uses a third-party service provider or its own representatives to deliver the prospectuses, it is important to have systems in place to monitor their timely delivery. It is also important for the firm to review reports it receives to monitor timeliness of delivery and take steps to remedy any deficiencies.

Specifically, firms using a third-party service provider to distribute their prospectuses should:

- Sign up for print-on-demand, so the service provider can make copies of any prospectus for which a copy is not available.
- Obtain and review daily reports from the service provider indicating whether any prospectuses have not been delivered on time.

- Identify the cause of any late delivery and take immediate steps to fix those problems.

Firms using their own representatives to provide prospectuses should:

- Clearly communicate to representatives that 100% compliance with Section 5(b)(2) is expected.
- Create a system in which representatives clearly document when they deliver a prospectus and use that information to monitor compliance on a daily basis.
- Ensure that there are alternative methods in place to provide customers with a prospectus if they do not receive one from their representative.
- Respond quickly to reports that prospectuses have not been provided on time.

Firms should also be aware of the availability of electronic delivery of prospectuses. In general, the federal securities laws do not require delivery in a particular medium and Securities Act Release No. 7233 (Oct. 6, 1995) states that electronic delivery, when reliability is comparable to paper delivery, can satisfy statutory requirements. In particular, the Release outlines three factors to take into consideration in making that determination: notice, access, and evidence of delivery. If there is a change to online versions of the document, the firms must provide their customers with notice, such as through an email, informing them of the new version. The firm must provide effective, continuous access to the document, comparable to the access one would have to a paper document, which can be satisfied by providing an opportunity to download a copy of the document. Finally, the firm must have reason to believe that the electronic means successfully delivered the document, such as consent to electronic delivery, email return-receipt, or confirmation of accessing, downloading, or printing the document.

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