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FINRA's Take On Internal Communications

Law360, New York (February 18, 2010) -- The Financial Industry Regulatory Authority recently brought four disciplinary actions that have the effect of imposing upon broker-dealers the obligation to ensure that internal-use-only materials contain the same cautions and disclaimers as pieces used with the public. Such an obligation is new.

Because the imposition of this obligation would have far-reaching consequences on compliance practice, the industry as well as the regulatory process would be better served through rulemaking, including the notice and comment procedure, rather than imposing this obligation through enforcement actions.

In fact, just several months ago, FINRA proposed extensive changes to its advertising rules, including reducing the current six categories to three (institutional communication, retail communication and correspondence) and requiring the filing of certain pieces that currently do not have to be filed. The proposal did not address the content standard for internal-use-only materials.

FINRA has, instead, brought enforcement actions that establish new standards for internal-use pieces. The theory behind these actions appears to be that unless a firm can point to specific disclaimers in internal use only material, it cannot establish that its representatives were aware of disclaimers and cautions relating to the product or to investing in general.

Thus, these recent disciplinary actions indicate that, at least in certain circumstances, FINRA is of the view that internal-use-only materials must include disclaimers equivalent to those required in marketing materials distributed to public customers.

Previous regulatory guidance relating to internal use only material primarily focused on the following two issues: (1) FINRA's concern that material was used only internally and not with investors; and (2) FINRA's concern that material was balanced.

Now, through a series of enforcement settlements, FINRA has expressed a new area of concern: whether internal-use-only material contains specific cautions regarding potential risks equivalent to those included in public materials. Previously, these types of cautions were typically included in sales material used with the general public, but not required for internal-use material.

The Cases

FINRA settled four actions involving internal use only pieces through Letters of Acceptance, Waiver and Consent (AWCs) against firms that sold Auction Rate Securities (ARS). Each firm was fined $150,000 to $250,000.

In each of these cases, FINRA specifically found that internal use only pieces were deficient because they did not contain risk disclosure of the type normally found in marketing materials used with the public.

In these settlements, FINRA found that the internal marketing materials (which often included internal Web sites and fact sheets for registered representatives) were deficient because they: (1) were not "fair and balanced"; (2) did not "provide a sound basis for evaluating the facts"; and/or (3) failed to disclose risk.

Thus, FINRA found that certain internal pieces did not specially disclose that ARS auctions could fail and that, therefore, customers might not be able to access their funds.

In addition, FINRA found that certain pieces failed to disclose all material differences between ARS and money market funds, including the differences in liquidity and safety.

Unanswered Questions

For decades, firms have treated internal-use-only pieces as being substantively different from sales material used with the public: pieces for customers and prospects needed to be balanced and clearly disclose risks; internal pieces, however, needed only to convey their message reasonably for their intended audience of industry professionals.

In contrast, these ARS settlements may mean that FINRA wants internal-use-only pieces (which are used by trained professionals registered with FINRA) to contain the same risk disclosures as material used by the investing public (who are presumed to be less informed than securities professionals).

The following are among the questions raised by the settlements:

- Will member firms, out of an abundance of caution, begin filing certain internal communications on a voluntary basis?

- Must routine internal communications (such as discussions about Morningstar ratings) begin to include boilerplate disclosures (including, "past performance is no guarantee of future results")?

- Will FINRA begin applying the standards established by the settlements to internal emails? If not, how will it distinguish between internal communications requiring disclosure and those that do not?

The Future

If FINRA believes that its standards for communications with the public should be applied to internal-only pieces, then it would seem more appropriate to engage in explicit rulemaking rather than rulemaking by enforcement.

The notice and comment function alerts the industry to issues FINRA considers important. Only through this process can firms express their views on issues, enabling policymakers to assess the merits of proposed changes.

Without industry input, FINRA runs the risk of quashing meaningful discussions that take place among industry professionals through internal-use-only materials, and broker-dealers run the risk of facing monetary and other sanctions if they fail to follow this new standard, which can be gleaned only by parsing through enforcement settlements.

If FINRA truly believes that internal-use-only materials should contain the same disclaimers and cautions as public-use pieces, it would serve both FINRA and its member broker-dealers to engage in rulemaking on this topic.

--By Deborah G. Heilizer (pictured), Clifford F. Kirsch and Brian Rubin, Sutherland Asbill & Brennan LLP

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