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Broker-dealer communications with the public, investors and FINRA (From Thomson Reuters Broker-Dealer Guide)

Jan 06 2017 Regulatory Intelligence news team

*This article is based on the newly updated **"Practitioner's Guide for Broker-Dealers,"** a multi-chapter resource from Thomson Reuters Regulatory Intelligence. The guide provides up-to-date commentary on topics pertaining to broker-dealer regulatory issues and offers practitioner tips on dealing with these important issues on a day-to-day basis. Each chapter of the **Broker-Dealer Guide** was prepared by industry experts who have tested their compliance advice in the marketplace.*

*We invite you to use the **Broker-Dealer Guide** as a reference tool in your firm's compliance efforts.*

Compendious laws and regulations govern the communications that broker-dealers and their registered representatives conduct with the public.

There are rules addressing which communications must be reviewed by a responsible person at a broker-dealer, and how long and by what means communications must be retained.

Other requirements impact the written supervisory procedures a broker-dealer must maintain and the manner by which those procedures must be evaluated for effectiveness by the brokerage.

Client statements, trade confirmations and other client communications are highly regulated, and a body of regulation has formed around electronic communications that have so transformed this area that broker-dealers may soon find that their records and communications are finally paperless.

Suitability

When recommending particular investments, broker-dealers generally have an obligation to recommend only such specific investments or investment strategies that are suitable for their customers.

FINRA Rule 2111 requires member firms to have "reasonable grounds for believing that a recommendation is suitable" for a customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile.

According to the SEC, each "broker-dealer has an obligation to investigate and obtain adequate information about the security or investment strategy it is recommending."

FINRA has published numerous Notices to Members regarding soliciting customers for highly speculative securities, such as certain low-priced shares, complex products, [private placements, complex hedging strategies and other derivative products.

Additionally, SEC Rule 15g-2 requires that broker-dealers, prior to recommending a penny stock to a customer, first approve the customer for the transaction and receive from the customer a written agreement to the transaction. The requirements for that document can be found in Schedule 15G under the Exchange Act.

The suitability rule has been deemed to be violated when a broker-dealer "recommends" to a customer a security that may be suitable for some investors, but is unsuitable for that particular customer. A broker-dealers use of general, impersonal advertising material, however, does not give rise to suitability obligations.

The concept of suitability permeates many aspects of communications with the public, including contact through new media such as text messaging, instant messaging and the use of social media.

The use of web-based tools, with their ability to reach many customers at once, can impose the high standard that recommendations made via these tools must be suitable for all members of the public that may read them.

Testimonials

FINRA Rule 2210(d)(6) requires that any person who gives a testimonial regarding a technical aspect of investing must have the knowledge and experience to form a valid opinion. FINRA Rule 2210(d)(6)(A) maintains that communications with the public using testimonials must comport with the following obligations:

- The testimonial may not be representative of the experience of other clients.
- The testimonial is no guarantee of future performance or success.
- If more than $100 is paid, the fact that it is a paid testimonial must be stated.

Compliance Tip

Note that while broker-dealers are allowed to use testimonials, subject to FINRA Rule 2210, investment advisers are prohibited under the Investment Advisers Act of 1940 (Advisers Act). Thus, dual registrant broker-dealers/registered investment advisers must comply with the more restrictive Advisers Act.

Communications with the public

FINRA Rule 2210 and interpretive materials under it, require broker-dealers to ensure that all communications with the public are based on principles of fair dealing and good faith, are fair and balanced, and provide a sound basis for evaluating the facts about any security or type of security, industry or service. These standards for the content of communications are detailed in FINRA Rule 2210(d)(1).

In addition to being covered by FINRA Rules 2210 and 2010, communications regarding investment companies, which include mutual funds, variable contracts and unit investment trusts, are also governed by specific SEC rules, as will be discussed later. Option communications must also comply with FINRA Rule 2220.

Municipal securities communications are constrained by the Municipal Securities Rulemaking Board Rule G-21 and G-27(d) although municipal fund securities (529 plans) communications offering registered investment company products may be subject to the filing and content standards of FINRA Rule 2210 (see NASD Special Notice to Members 03-17) as well as MSRB Rule G-21.

Per FINRA Rule 2210(d)(1), no broker-dealer may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading.

Communications may not contain predictions or projections of investment results. Additionally, broker-dealers may not make any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public, or publish, circulate or distribute any public communication that the firm knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

FINRA is on guard against "scams, false promises of unrealistic investment returns and other improper communications."

Misleading communications can take a number of forms. In May 2008, FINRA released a regulatory notice (Regulatory Notice 08-27) establishing rules regarding brokers' use of "canned" or ghost-written articles and books.

FINRA observed that some registered representatives were merely affixing their names to investment-related publications that had largely or entirely been written by others, including services specializing in such ghost-written work. "Registered representatives may not suggest (or encourage others to suggest) that they authored investment-related books, articles or similar publications if they did not write them."

Members should also be aware that FINRA Rule 2210 prohibits firms and brokers from "referencing non-existent or self-conferred degrees or designations, or referencing legitimate degrees or designations in a misleading manner." (See interpretive guidance.)

Therefore firms "must have adequate supervisory procedures in place to ensure that their registered representatives do not violate this requirement."

Compliance Tip

A common-sense approach is for members to permit only earned designations related to a registered representative's duties with the firm (e.g., "Certified Financial Planner") to be included in communications with the public, while prohibiting the use of designations not pertinent to the representative's job requirements and possibly misleading (e.g., "Attorney at Law" may lead a customer to assume she is receiving legal advice).

Additionally, broker-dealers should perform due diligence on all registered representatives who use professional designations to confirm that they do in fact possess the qualification and are currently entitled to use the designation.

Internal communications

Internal communications are an unsettling area of broker-dealer regulation. The long-held view was that internal communications were "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 addition, firms were concerned that items marked for "internal use only" should not be sent or otherwise provided to persons outside of the member firm. Squawk boxes, conference calls and other proprietary communications were to be protected from access by outsiders. These considerations still pertain.

However, beginning in 2009, FINRA announced settlements with firms marketing auction rate securities (ARS).

Among the behaviors sanctioned by FINRA was a firm's providing "internal communications with its sales force that were not fair and balanced and therefore did not provide a sound basis for investors to evaluate the benefits and risks of purchasing ARS.

In particular, the firms failed to adequately disclose to customers the potential for ARS auctions to fail and the consequences of such failures."

This appears to indicate that internal communications may be held to a similar standard to those of communications with the public, including disclosure of all appropriate risk factors.

Social networking

In light of the ever-increasing use of electronic communications in the broker-dealer environment, FINRA has been active in regulating these newer tools. Compliance requirements and pitfalls abound.

As is the case with their older paper-based cousins, many of these items must be pre-approved by a registered principal. Some communications must also be filed with FINRA. As with any broker-dealer communication, these newer formats must be fair and balanced and disclose material facts and not contain claims or statements that are false, misleading or unwarranted.

As discussed earlier, FINRA sees electronic communications — including social media and other Web 2.0 phenomena — as falling into categories that were established for pre-Internet communications:

"Communications" consist of correspondence, retail communications and institutional communications.

"Correspondence" means any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30 calendar-day period.

"Retail communication" means any written (including electronic) communication that is distributed or made available to more than 25 retail investors (current or prospective retail customer) within any 30 calendar-day period.

Communications that were previously considered advertisements, sales literature, and independently prepared reprints sent to more than 25 retail investors within a 30 calendar-day period, generally fall under the definition of "retail communication." Additionally, sales scripts that are intended for use with retail customers are considered retail communications.

An email or instant message sent to 25 or more prospective retail customers Chat-room discussions are also considered retail communications.

"Institutional communication" means any written (including electronic) communication that is distributed or made available only to institutional investors, but does not include the Company's internal communications. The Company may not treat a communication as being institutional if the Company has reason to believe that the communication or any excerpt of the communication is being forwarded to any retail investor.

The distinctions between the categories can be subtle; what, for instance, would be the practical difference between a chat-room appearance and posting to a blog? FINRA explains that, because websites are used to communicate with the public and customers, and because there is little control over who views the material, the blog is retail communications.

These same conditions would appear to pertain in the case of a chat room, but FINRA instead likens it to a public appearance. As FINRA notes, however, "a member firm's obligations to supervise electronic communications are based on

the content and audience of the message, rather than the electronic form of the communication."

Much has been made of the marketing opportunities and compliance pitfalls of social networking outlets such as Twitter, LinkedIn, Facebook and blogs. And, in spite of recent guidance from FINRA, questions remain regarding compliance standards for this electronic frontier.

Some member firms have reportedly reacted to the uncertainty by banning or severely restricting social media participation by their representatives. Bans have taken various forms, with several large firms forbidding all use of social media websites, both private and professional. Other firms permit use of the sites outside of the office, but prohibit representatives from discussing their work.

One major firm allows pre-approved biographical material to be posted to the LinkedIn website, but forbids use of other sites. Some firms permit the use of static content on a social media site. Static content includes content such as a profile, background or wall information.

Generally the firm will approve the information on a business card or prior approved language but will not permit any additional information to be posted on a social media site. With technological advancements firms are beginning to expand the use of social media but no matter what the form of the media (text messaging, instant messaging or social media sites) the member firm has the obligation to review and archive as written correspondence.

Compliance Tip

Representatives' responsibilities under the communications rules should certainly be an important theme in the annual compliance meeting required by FINRA Rule 3110(a)(7).

Authors of the Broker-Dealer Guide's communications chapter, on which this article is based, are: Deirdre Patten, CEO and Principal of Patten Training in Texas; Dan LeGaye, a licensed Texas attorney and founding partner of The LeGaye Law Firm P.C., and Michael R. Schaps, Director of Regulatory Compliance for The LeGaye Law Firm.

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