Regulatory Notice 08-81

December 2008

High Yield Securities

FINRA Reminds Firms of Their Sales Practice Obligations with Regard to the Sale of Securities in a High Yield Environment

Executive Summary

FINRA is issuing this *Notice* to remind firms of their obligations in the sale of securities such as bonds, bond funds, structured products and non-conventional investments, in a high-yield environment.[1] The yield on many of these instruments in late 2008 reached unusually high levels, which may increase their appeal to some investors. FINRA reiterates the guidance set forth in previous *Notices* and reminds firms that they are obligated to balance any discussion of yield with an appropriate discussion of the features of these instruments and the risks presented.[2]

Questions concerning this *Notice* should be directed to Angela C. Goelzer, Associate Vice President, Investment Company Regulation, at (202) 728-8120.

Background & Discussion

Notice to Members 04-30 reminds firms that while bonds and bond funds can play an important role in stabilizing diversified portfolios, neither product is risk-free. Terms, conditions, risks, and returns vary widely, and in some cases risks may be substantial. The *Notice* reminds firms of their responsibility to take appropriate steps to ensure that their associated persons understand and present balanced discussions about the risks as well as the returns of the products that they sell.[3] *Notices to Members 05-59* and *03-71* provides comparable guidance to firms concerning, respectively, the sale of structured products and non-conventional investments.

Notice Type

- Special Alert

Suggested Routing

- Advertising
- Compliance
- Legal
- Senior Management
- Training

Key Topic(s)

- Bond Funds
- Bonds
- Disclosure
- Non-Conventional Investments
- Structured Products
- Yield

Referenced Rules & Notices

- NASD IM-2210-1
- NASD Rule 2210
- NASD Rule 2310
- Notice to Members 05-59
- Notice to Members 04-30
- Notice to Members 03-71

Financial Industry Regulatory Authority

Higher yield may make an investment more appealing to some investors. However, firms must take appropriate steps to understand the terms, conditions, risks and rewards of any security that they sell to retail customers by performing a "reasonable-basis suitability analysis." Firms also must determine that such an investment is appropriate for a particular customer before recommending it to that customer by performing a "customer-specific suitability analysis." Both the reasonable-basis and customer-specific suitability analyses require consideration of the various risks associated with any security, including a security that is sold for its high yield.[4]

Sales materials and oral presentations must present a fair and balanced picture regarding both the risks and benefits of investing in these products. FINRA reminds firms that NASD Rule 2210 and IM-2210-1 require firms to ensure that statements are not misleading within the context in which they are made, and that firms must consider the nature of the audience to which a communication is directed. Firms must take appropriate steps to ensure that any discussion between an associated person and a customer concerning the high yield associated with a particular security is balanced with a discussion of its risks. Firms must avoid encouraging a customer to place undue reliance on yield as a factor to be considered in selecting an investment.

For example, any presentation to a customer concerning an investment's yield should be balanced with a discussion of any applicable credit risk or risk of default associated with the issuer, and how that risk might affect the safety of the invested principal. Similarly, a presentation concerning the high yield of a bond fund should be balanced by a discussion concerning the credit risk associated with the fund's portfolio and the risk that the fund's net asset value could decline. The discussion also should address interest rate risk – the risk that interest rate changes might affect the market value of an instrument prior to its call or maturity date.

Finally, the firm should consider the liquidity risk that might be associated with the product. Since many bonds and unconventional products trade infrequently or irregularly (and not like exchange traded equities), customers should be made aware that their sales may not always be executed immediately or that sales may occur at prices well below a customer's purchase price or anticipated market price.

Firms also must adequately train and supervise employees who sell these securities, and implement adequate supervisory controls to reasonably ensure compliance with FINRA and SEC sales practice rules.

Firms are encouraged to review the previous FINRA guidance referenced in this *Notice* for a fuller discussion of applicable sales practice obligations.

Endnotes

1 *Regulatory Notice 08-82*, also issued December 16, 2008, addresses firms' sales practice obligations with regard to cash alternatives.

2 *See* NASD Reminds Firms of Sales Practice Obligations in Sale of Bonds and Bond Funds, *NTM 04-30* (April 2004). *See also* NASD Provides Guidance Concerning the Sale of Structured Products, *NTM 05-59* (September 2005) and NASD Reminds Members of Obligations When Selling Non-Conventional Investments, *NTM 03-71* (November 2003).

3 A pending FINRA Rule proposal would require enhanced disclosure to customers at confirmation of transactions in certain TRACE-eligible debt securities. The disclosure would provide transaction-specific information relating to charges, credit ratings, the availability of last-sale transaction information, and certain interest and call provisions. The proposal also would require that customers in these securities receive notice of the availability of "Important Information You Need to Know About Investing in Corporate Bonds," authored by FINRA. *See* Securities Act Rel. No. 56661 (October 19, 2007).

4 *See* Rule 2310. For municipal securities, *see* Municipal Securities Rulemaking Board (MSRB) Rule G-19 (Suitability of Recommendations and Transactions; Discretionary Accounts) and G-17 (Conduct of Municipal Securities Activities).