Regulatory Notice 08-82

Cash Alternatives

FINRA Reminds Firms of Their Sales Practice Obligations with Regard to Cash Alternatives

December 2008

Notice Type
- Special Alert

Suggested Routing
- Advertising
- Compliance
- Legal
- Senior Management
- Training

Key Topic(s)
- Cash Alternatives
- Disclosure

Referenced Rules & Notices
- NASD IM-2210-1
- NASD Rule 2210
- NASD Rule 2310

Executive Summary

FINRA is issuing this *Notice* to remind firms of their obligations in the sale of investments as alternatives to cash holdings.[1] This *Notice* provides guidance to firms concerning the requirements to:

1. avoid overstating a product's similarities to a cash holding and provide balanced disclosure of the risks and returns associated with a particular product;
2. conduct adequate due diligence to understand the features of a product;
3. conduct appropriate suitability analyses;
4. monitor market and economic conditions that may cause the description of an investment as a cash alternative to become inaccurate or misleading, and adopt procedures reasonably designed to ensure that the firm responds to those changing conditions; and
5. train registered persons regarding the features, risks and suitability of these products.

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

Financial Industry Regulatory Authority

Background & Discussion

In recent years, firms have sold a wide variety of investments as alternatives to cash holdings. These cash alternatives can represent an important component of an investment portfolio. Although they typically offer lower rates of return than longer-term equity or fixed-income securities, they provide a level of liquidity and price stability typically not available to these other investments. The types of investments that have been sold as cash alternatives include:

- Auction rate preferred or fixed income securities;
- Bank certificates of deposit;
- Bank money market accounts;
- Bankers' acceptances;
- Commercial paper;
- Federal agency short-term securities;
- Fixed rate and step-up callable corporate securities;
- Floating rate funds;
- Guaranteed investment contracts;
- Money market mutual funds;
- Municipal notes;
- Repos and swaps;
- Structured investment vehicles;
- Treasury bills;
- Ultra-short bond mutual funds or exchange traded funds; and
- Variable rate demand notes.

Many of these products are well-known. Some, such as bank certificates of deposit and bank money market accounts, offer the protection of federal deposit insurance on accounts up to $100,000.[2] U.S. Treasury bills are backed by the full faith and credit of the United States government. Money market mutual funds, though traditionally lacking federal insurance and not without risk, are highly regulated under federal law and historically have provided a dependable level of stability and liquidity.[3] Information about the advantages and disadvantages of each of these types of cash alternatives is readily available.

Other investments that are marketed and sold as cash alternatives may not be as well-understood by the financial markets and may present risks that are less apparent to some investors. Recent experience with auction rate securities is a case in point.

Since their development in the 1980s, some firms have sold these securities as a cash alternative, and in recent years they became a popular choice among both retail and institutional investors. Developments in the credit markets led many auctions to fail in recent months. As a result, many investors who believed their auction rate securities holdings to be almost as conservative and liquid as cash found themselves with illiquid holdings of uncertain value.

Similarly, some investors may have failed to appreciate the differences between ultra-short bond funds and money market mutual funds. Ultra-short bond funds, like money market funds, are mutual funds that generally invest in fixed-income securities with short maturities. In some cases, firms have sold these funds as "cash-enhanced" products. However, money market funds may only invest in certain high-quality, short-term investments issued by the U.S. government, U.S. corporations and state and local governments and they are subject to strict diversification and maturity standards. Ultra-short bond funds are not subject to these requirements and typically pursue strategies aimed at producing higher yields by investing in securities with higher risks. The net asset value (NAV) of an ultra-short bond fund will fluctuate, while money market funds seek to maintain a stable NAV of $1 per share. Indeed, during the recent credit crisis, some ultra-short bond funds experienced a dramatic increase in redemptions and decline in their share price.

Communications with the Public

Sales materials and oral presentations regarding cash alternatives 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. In virtually all cases, a statement to retail investors that an investment is a "cash equivalent," that it is as "safe as cash" or that it carries no market or credit risk would raise serious questions under FINRA's advertising rules.

Firms must take reasonable steps to ensure that any communication that presents an investment as a cash alternative discloses, if applicable, that it is not federally guaranteed and that it is possible to lose money with the investment. Firms may not claim that a product is an alternative to cash unless the statement is fair and accurate. When it is appropriate to describe a product as a cash alternative, this description must be balanced with disclosures of the corresponding risks and limitations of the product. In the case of cash alternatives, this includes, but is not limited to, factors that could reasonably be anticipated to affect the liquidity or price stability of the investment, as well as the ability of the issuer to repay its obligation in full. In the event that market or economic developments affect the continued accuracy of a characterization of a product as a cash alternative, firms should promptly review their promotional materials and promptly make the necessary changes to ensure that investors are not misled.

FINRA reminds firms, however, that simply providing a prospectus or offering memorandum does not cure unfair or unbalanced sales or promotional materials.

Due Diligence/Reasonable-Basis Suitability

Performing appropriate due diligence is crucial to a firm's obligation to undertake its required reasonable-basis suitability analysis under FINRA's suitability rule, NASD Rule 2310. A reasonable-basis suitability determination helps ensure that an investment is suitable for at least some investors (as opposed to a customer-specific suitability determination, which is undertaken on a customer-by-customer basis). A reasonable-basis suitability analysis requires a firm to understand the investment products it sells. Accordingly, a firm must perform appropriate due diligence to ensure that it understands the nature of a product that it is recommending, including its potential risks and rewards.

A firm must have a reasonable basis for characterizing an investment as a cash alternative, and it is not sufficient simply to rely upon a third-party's characterization. The firm also must monitor market and economic developments that may affect the continued accuracy of a characterization of an investment as a cash alternative, and have procedures to quickly alert its sales and marketing staff to developments that will make such a characterization unwarranted. The fact that a firm intends to describe an investment as a cash alternative only to institutional investors does not relieve the firm of its responsibility to conduct due diligence and a reasonable-basis suitability analysis.

Customer-Specific Suitability

Firms must reasonably believe that a product is suitable for a customer seeking a cash alternative before recommending it as such. FINRA cautions firms that the fact that an investment may meet established accounting standards for treatment as a cash holding in a financial statement does not conclusively establish that the investment is an appropriate cash alternative for a particular investor. To ensure that a particular investment is suitable as a cash alternative for a specific customer, firms and their registered persons must examine the customer's need for liquidity and price stability, and the ability of the investment to meet that need. As with other suitability determinations, the following factors are relevant:

➤ the customer's financial status;
➤ the customer's tax status;
➤ the customer's investment objectives; and
➤ such other information used or considered to be reasonable by the firm or registered representative in making recommendations to the customer.

Training

Firms must train registered persons about the characteristics, risks and rewards of each product before they allow registered persons to recommend that product to investors. Likewise, firms should train registered persons about the factors that would make such products either suitable or unsuitable for certain investors. In the case of a cash alternative, training should encourage extreme caution in characterizing a product to an investor as an alternative to cash.

Endnotes

1 *Regulatory Notice 08-81*, also issued December 16, 2008, addresses firms' sales practice obligations with regard to the sale of securities in a high-yield environment.

2 Under FDIC coverage, if a bank or savings association fails, each depositor generally is insured for up to $100,000 ($250,000 effective October 3, 2008, through December 31, 2009) for non-retirement accounts, and up to $250,000 for IRAs and certain other retirement accounts. The FDIC coverage does not insure securities or mutual funds. More information can be found at *www.fdic.gov* or by contacting the FDIC at (877) ASK-FDIC.

3 Recent events demonstrate that money market funds are not risk-free investments. On September 16, 2008, The Reserve announced that the Reserve Primary Fund, a money market fund, had fallen below $1 per share. The U.S. Treasury Department has established a Temporary Guarantee Program to ensure that investors in participating funds will receive $1 for each money market fund share held as of close of business on September 19, 2008.