

FINRA REMINDS FIRMS OF THEIR REVERSE CONVERTIBLE NOTE SALE OBLIGATIONS, ANNOUNCES ENFORCEMENT ACTION SETTLEMENT RELATED TO REVERSE CONVERTIBLE NOTE SALES

The Financial Industry Regulatory Industry (“FINRA”) recently issued a Regulatory Notice reminding member firms of their sales practice duties to ensure that promotional materials and public communications regarding reverse convertible notes (“RCNs”) are fair, balanced, and do not overstate the level of protection offered or an investment’s potential returns. Firms are also reminded of their duty to ensure that registered representatives understand the products’ risks, terms, and costs and that they are required to perform adequate suitability analysis before recommending RCNs to a customer. At the same time, FINRA released an Investor Alert entitled “Reverse Convertibles - Complex Investment Vehicles” (the “Investor Alert”) to educate retail investors about how RCNs work, the risks involved, and what factors to consider before investing in an RCN.

The full text of Regulatory Notice 10-09 (the “Notice”) is located at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120920.pdf>. The Notice should be read in conjunction with FINRA Notice to Members 05-59 which provides guidance to members concerning their obligations when selling structured products, including the requirements to: (1) provide balanced disclosure in promotional efforts; (2) ascertain accounts eligible to purchase structured products; (3) deal fairly with customers with regard to derivative products; (4) perform a reasonable-basis suitability determination; (5) perform a customer-specific suitability determination; (6) supervise and maintain a supervisory control system; and (7) train associated persons. Notice to Member 05-59 is located at <http://www.finra.org/Industry/Regulation/Notices/2005/P014997>. The full text of the Investor Alert is located at <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P120883>.

FINRA also announced its first enforcement action involving the sales of RCNs (the “Enforcement Action Announcement”), fining a member firm \$200,000 for failing to establish adequate supervisory systems and procedures for supervising sales of RCNs to retail customers. FINRA also fined and suspended a broker for making unsuitable sales of RCNs to a retired couple. The firm was ordered to pay \$75,000 in restitution to the couple for losses they incurred.

RCNs

Investors have been attracted to RCNs in recent years largely because they offer higher yields than on a conventional debt instrument of the issuer with a similar maturity, or of an issuer with a comparable debt rating. These securities are structured products that typically consist of a high-yield, short-term note of the issuer that is linked to the performance of an unrelated reference asset, usually common stocks. Most RCNs have maturity dates ranging from three months to one year.

The higher yield reflects the risk that the investor could receive less than the full return of principal at maturity if the value of the reference asset has fallen below a certain level, often referred to as the “knock-in” or “barrier” level. Depending on the underlying asset, the investor could receive a predetermined number of shares of common stock (or cash equivalent), which would amount to less than the investor’s original investment. Each RCN has its own terms and conditions, but, generally, if the price of the reference asset remains above the knock-in level throughout the life of the note, the investor will

receive a full return of principal. In some cases, the investor will also receive a full return of principal if the price of the reference asset ends above the knock-in level at maturity, even if it has fallen below the level during the term of the investment; in other cases, any breach of the knock-in level will trigger repayment of less than the original principal (e.g., in shares of stock). However, the investor typically will not participate in any appreciation in the value of the reference asset during the life of the note. In effect, the investor in the RCN is selling the issuer a put option on the reference asset in exchange for an above-market coupon during the life of the note. Generally speaking, the higher the coupon rate, the higher the expected volatility of the reference asset, which in turn means a greater likelihood that the knock-in price will be breached and the investor will receive less than a full return of principal at maturity.

Because the note component of a RCN is an unsecured debt obligation of the issuer, the payment of the coupon is subject to the credit risk of the issuer. While the note carries the issuer's rating, that rating does not reflect the product's market risk, including the risk that the price of the reference asset will fall below the knock-in level. Some RCNs have call provisions that give the issuer the option to require redemption of the investment before maturity. There may also be complex tax implications associated with RCNs, with tax treatment depending on whether the investor receives a return of principal or stock at maturity.

Disclosure Obligations

NASD Rule 2210 requires that all communications with the public, including advertisements and public appearances, present a fair and balanced description of both risks and potential benefits. For example, communications with the public should disclose the product and liquidity information noted above to the extent reasonably necessary to balance any discussion of the benefits and advantages of a RCN. NASD Rule 2210 also prohibits exaggerated, unwarranted, or misleading statements and the omission of any material fact or qualification that would cause the communication to be misleading. Before marketing a RCN to a retail customer, therefore, the Notice reminds firms that they should discuss the product with the customer to ensure that the customer makes an informed decision about whether to purchase the RCN. The Notice provides that a registered representative and retail customer should discuss such matters as the following:

- how the product works, including its payout structure, relevant information about the reference asset and, if applicable, that the investor will not participate in any appreciation in the value of the reference asset;
- the fact that the principal value of the investment is not guaranteed and the customer might suffer a loss on the investment;
- the ability of an investor to sell the product prior to maturity, and the potential sales price, may depend on the willingness of the issuer or another party to maintain a secondary market; and
- if applicable, the fact that the firm has published its own research reports regarding the reference asset, the content of that research and how the research is or is not relevant to a recommendation to purchase or sell the RCN.

In addition, the Notice provides that firms and their registered representatives should not suggest that RCNs are ordinary debt securities. If a firm or registered representative refers to the product's credit rating, they may not suggest that the rating has any bearing on the expected performance of the reference asset, nor may they exaggerate the probability that the investor will receive a full return of principal. Firms must not present annualized yield or coupon information for reverse convertibles in a misleading manner. For example, a 10 percent per annum coupon provides an actual return of roughly 2.5 percent (based on a 360-day year) over a three-month term. The Notice reminds firms

that for products that mature in less than a year, they must balance any communication that promotes or touts annualized yield with prominent disclosure of the actual percentage return and the term of the note. FINRA believes that such disclosure in a prospectus supplement would not cure an otherwise deficient communication, even if such sales material is accompanied or preceded by the prospectus supplement.

Supervision and Training Obligations

The Notice reminds firms that they must have adequate written supervisory procedures and supervisory controls that are reasonably designed to ensure that sales of RCNs comply with the federal securities laws and FINRA rules. Firms must also adequately train employees who sell, or who supervise those who sell, RCNs. The Notice provides that RCN training should emphasize, among other things:

- the costs and risks associated with the product;
- the terms and conditions of the product, including the pay-out structure at maturity;
- the reference stock, index or other asset;
- the investment's potential for growth;
- the product's liquidity before maturity; and
- any other features that might impact the product's suitability, both generally and for a specific customer.

Suitability Obligations

NASD Rule 2310 requires that firms have a reasonable basis for determining that a product is suitable, both generally and for specific customers, by performing adequate due diligence. This requires careful review and understanding of the risks, costs, terms, and conditions of a product being offered. Before executing a recommended transaction, firms are required to make reasonable effort to obtain information about the investor's financial status, tax status, investment objectives, and other information used to make a recommendation. The Notice provides that before recommending any RCN, therefore, firms should consider and fully understand, among other things:

- its payout structure;
- its call features;
- the conditions under which the investor would and would not receive a full return of principal;
- the volatility of the reference asset; and
- the product's credit, market and other risks.

In addition, the Notice reminds firms that even an above market coupon rate may not be reasonable given the risks and costs associated with the product for a particular customer. FINRA further suggests that firms should also consider the equity position that would result should the customer receive shares in the reference asset instead of a return of principal, and whether that position would be suitable for the customer.

Finally, firms are reminded that NASD IM-2310-2(e) emphasizes firms' obligations to deal fairly with customers and make every effort to familiarize themselves with each customer's unique financial situation when making recommendations or accepting orders for new financial products, such as RCNs.

FINRA Enforcement Action Announcement

In the Enforcement Action Announcement, FINRA found that during the period from January 2004 through December 2007, a member firm engaged in sales of RCNs without having a system or procedures in place to effectively monitor customer accounts for potential over-concentrations in RCNs. As a result, the firm failed to detect and respond to indications of potential over-concentration in RCNs in numerous customer accounts.

FINRA found that the member firm utilized an automated surveillance system to facilitate its suitability review of securities transactions and to monitor customer accounts for potentially unsuitable positions and activity. The system would flag for review any transaction or account meeting certain parameters established by the firm relating to, for example, account turnover and concentration levels in a particular security or class of security. The firm's system, however, was not configured or designed to monitor RCN transactions or RCN positions in customer accounts and the firm did not establish an effective alternative means to do so. As a result, the member firm failed to detect and respond to indications of potentially unsuitable RCN concentration levels in numerous customer accounts. Additionally, the firm failed to provide sufficient guidance to its supervising managers on how to assess suitability in connection with their brokers' recommendation of RCNs.

FINRA found that the retired couple receiving restitution had, on the broker's recommendation, invested nearly 40 percent of their total liquid net worth in nine RCNs. This exposed the customers to a risk of loss that was inconsistent with their investment objectives and risk tolerance and which ultimately resulted in substantial loss. In addition to the fines imposed on the firm, FINRA also suspended the individual broker from associating with any FINRA regulated firm in any capacity for a period of 15 days, fined him \$10,000, and ordered him to disgorge \$2,023 in commissions that he earned from his sales of RCNs to the couple. In concluding this settlement, the firm and the individual broker neither admitted nor denied the charges, but consented to the entry of FINRA's findings.

The Enforcement Action Announcement also noted that in the coming weeks, FINRA will be offering formal and informal instruction in RCN sales compliance on its website, <http://www.finra.org/education>.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Corporate Finance and Securities Group or visit us online at chapman.com.

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material. © 2010 Chapman and Cutler LLP. All Rights Reserved.

Chapman and Cutler LLP is an Illinois limited liability partnership that has elected to be governed by the Illinois Uniform Partnership Act (1997).