

Client Alert

Current Issues Relevant to Our Clients

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SEC Issues Risk Alert Noting Broker-Dealer Deficiencies in Structured Product Sales

The Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations recently issued a Risk Alert summarizing deficiencies in controls of certain broker-dealers related to sales of structured products to retail investors. The Risk Alert follows a series of examinations of branch offices of broker-dealers that distribute structured products issued as securities. The SEC staff found that in connection with these structured products sales all of the examined firms:

- failed to maintain and/or enforce adequate controls relating to determining the suitability of recommendations; and
- failed to conduct both compliance and supervisory reviews of registered representatives' determinations of customer suitability as required by their internal controls.

The Risk Alert is available [here](#).

Background

Structured products typically include securities issued in the form of corporate notes or certificates of deposit issued by banks. Structured products typically provide a return linked to one or more underlying assets, such as a single security, baskets of securities, indices, options, commodities, and/or currencies. Structured products may also supply principal protection, interest payments, or leveraged exposure to the referenced asset, among other things. These products generally offer investment characteristics that resemble a debt obligation combined with an embedded derivative. The Risk Alert appears to focus on structured products that constitute "securities" under the federal securities laws ("SSPs"). SSPs generally do not include structured certificates of deposit issued by a bank.

As with other securities products, broker-dealers have suitability obligations with respect to SSP transactions under the federal securities laws and Financial Industry Regulatory Authority ("FINRA") rules. FINRA rules also require broker-dealers to supervise their associated persons with a view to preventing violations of securities laws. FINRA has released guidance to help assess the adequacy of controls that broker-dealers should include in their supervisory and compliance procedures with respect to structured products and complex products. A firm's controls should include provisions relating to a reasonable basis suitability determination; customer-specific suitability analysis; and training for registered representatives regarding the characteristics, risks, and rewards of these

products. For more information on FINRA's guidance, please see our Client Alert available [here](#).

Structured products are increasingly being marketed to retail investors seeking higher yielding investments in the current low interest rate environment. The SEC examined ten branch offices of registered broker-dealers that distribute SSPs issued by their parents or affiliates or issued by unaffiliated third parties covering the period of calendar years 2011 and 2012. The SEC staff assessed these firms' compliance with suitability and supervision requirements and evaluated whether the firms effectively supervised and monitored activities and risks associated with sales of SSPs to retail investors.

Among other things, the SEC staff examinations revealed several significant deficiencies in the areas of suitability and supervision with respect to all of the examined firms' sales of SSPs to retail investors. Specifically, the SEC staff found that all of the examined firms (1) failed to maintain and/or enforce adequate controls relating to determining the suitability of SSP recommendations; and (2) failed to conduct both compliance and supervisory reviews of registered representatives' determinations of customer suitability in the SSPs, as required by their internal controls.

Deficiencies in Suitability Determinations

The SEC staff cited all of the examined firms for failing to maintain and enforce policies and procedures relating to determining the suitability of recommendations of SSPs.

All of the examined firms had policies and procedures governing suitability, processes for product development and approval, and training of representatives. However, the SEC staff found instances in which such controls were inadequately or inconsistently implemented.

For example, the review of SSP trading at four branch offices of one firm revealed that the firm sold more SSPs to customers in its most conservative investment objective than it did to customers in its most aggressive investment objective. The staff also noted that certain registered representatives within one firm in particular were aggressively recommending SSPs to customers while appearing to mischaracterize the underlying attributes of the products in light of the goals of the investors. In addition, the SEC staff noted that representatives at one firm had retroactively changed customers' investment objectives in their account documentation, without the customers' approval, in order to justify concentrated positions of SSPs in the portfolios. The SEC staff's review of trade blotters further indicated that various account types had a large number of SSP purchases during the two-year review period, and many of these SSPs were thereafter liquidated at well below face value of the SSP.

Failure to Conduct Compliance and Supervisory Reviews

The examinations revealed that all of the examined firms failed to enforce their written supervisory procedures relating to reviews of representatives' determinations of suitability with regard to SSPs. Additionally, the implementation of the firms' procedures varied across branches of the same firm.

For example, one firm's written supervisory procedures stated that all SSP holdings should not exceed a certain percentage of the client's stated liquid net worth. The SEC staff's exam, however, uncovered that, at one branch, approximately 60% of SSP transactions exceeded the firm's concentration guidelines. Moreover, this firm had a system in place to alert representatives and supervisors of breaches of concentration guidelines. This system required, in part, a review and documentation of reasons for an override of the firm's guidelines. At this particular branch, all of these transactions had been approved by the branch manager or complex risk officer with little or no documented explanation to support their approvals.

What Should Firms Do Now?

The SEC staff Risk Alert is intended to highlight risks and issues identified in SEC exams. The Risk Alert describes factors that the SEC staff suggests broker-dealers may consider to (1) assess their supervisory, compliance and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Firms that distribute structured products should consider reviewing compliance policies and procedures in light of these factors.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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