Client Alert

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FINRA: Complex Products Require Heightened Supervision—Focus on Structured Notes, Inverse/Leverage ETFs, Hedge Funds, Securitized Products, and Similar Products

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently issued guidance to members concerning the supervision of complex products — securities or investment strategies with novel, complicated, or intricate derivative-like features such as structured notes, inverse or leveraged exchange-traded funds, hedge funds, and securitized products. FINRA believes that such features may make it difficult for retail investors to understand the essential characteristics of complex products and their risks. As discussed below, FINRA also identified characteristics that may render a product "complex" for purposes of determining whether such product should be subject to heightened supervisory and compliance procedures. The related FINRA Regulatory Notice is available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125397.pdf.

Background

FINRA has issued several Regulatory Notices in recent years to remind members of their obligations with respect to various products that raise specific investor protection concerns, specifically with relation to new and potentially complex products. Some of these products include hedge funds, equity-indexed annuities, structured products, leveraged and inverse exchange-traded funds, principal protected notes, reverse convertibles, among others. Because of the possibility that such products will not perform as investors anticipate, or that such product may not be appropriately sold (such as on the basis of enhanced yield, principal protection, or the tracking of an index), the Regulatory Notices have advised members to adopt procedures for vetting such products and supervising their sale and marketing to retail investors. The Securities and Exchange Commission ("SEC") has similarly expressed concerns about complex products in recent years and has brought a number of enforcement cases involving sales of complex investments.

The recent Regulatory Notice provides guidance on supervision of complex products by FINRA member firms. While FINRA does not define "complex products" or provide an exhaustive list of features that may render a particular product "complex", the current guidance attempts to identify characteristics that may help FINRA members identify complex products that warrant enhanced compliance and supervisory procedures.

What is a Complex Product?

FINRA notes that a product is potentially complex if it has multiple features that affect its investment returns differently under various scenarios. This is particularly true if it would be unreasonable to expect an average retail investor to discern the existence of these features and to understand the basic manner in which these features interact to produce an investment return. Examples of complex products include the following, among others:

- Asset-backed securities and unlisted REITs;

- Products that include an embedded derivative component (such as “steepener” notes, reverse convertibles, and certain other structured products);
- Range accrual notes and other products with contingencies in gains or losses;
- Structured notes with “worst-of” features, which provide payoffs that depend upon the worst performing reference index in a specified group;
- Investments tied to the performance of markets that may not be well understood by many investors (such as ETFs/ETNs offering exposure to market volatility or inverse or leveraged returns);
- Products with conditional or partial principal protection;
- Products with “daily reset” return formulas rather than “point-to-point” returns; and
- Products with complicated limits or formulas for the calculation of gains (such as notes that track upside performance of an asset up to a specified threshold and thereafter return a reduced payoff to a much lower, pre-set level, regardless of future performance).

FINRA’s list of characteristics is not exhaustive, and products without the listed characteristics may nevertheless require heightened compliance and supervisory procedures. FINRA notes that the fundamental point for members is that if a product has similar features of complexity, then firms should err on the side of applying their procedures for enhanced oversight to the product.

Heightened Supervision and Product Approval

FINRA rules require members to perform a reasonable basis suitability determination before recommending a transaction or investment strategy involving a security. Among other factors, the determination of reasonable diligence depends on the complexity, risks, and member’s familiarity with the particular security or investment strategy. Reasonable diligence should provide the member with an understanding of the potential risks and rewards associated with the recommended security or strategy and should be informed by an analysis of likely product performance in a wide range of normal and extreme market actions. FINRA reminds firms to have formal written procedures to ensure that their registered representatives do not recommend a complex product to a retail investor before it has been thoroughly vetted. FINRA suggests that the following questions should be answered before a complex product is recommended to retail investors:

- For whom is this product intended? Is the product proposed for limited or general retail distribution, and, if limited, how will it be controlled?
- Conversely, to whom should this product not be offered?
- What is the product’s investment objective, and is that investment objective reasonable in relation to the product’s characteristics? How does the product add to or improve the firm’s current offerings? Can less complex products achieve the objectives of the product?
- What assumptions underlie the product, and how sound are they? How is the product expected to perform in a wide variety of market or economic scenarios? What market or performance factors determine the investor’s return? Under what scenarios would principal protection, enhanced yield, or other presumed benefits not occur?
- What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks to principal?
- How will the firm and registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed?
- Does the product present any novel legal, tax, market, investment, or credit risks?
- Does the product’s complexity impair understanding and transparency of the product?
- How does this complexity affect suitability considerations or the training requirements associated with the product?
- How liquid is the product? Is there an active secondary market for the product?

Post-Approval Review

FINRA notes that a firm's internal controls should include a process to periodically reassess the complex products it offers to determine whether performance and risk remain consistent with the manner in which the firm is selling them. FINRA believes that firms should also consider developing procedures to monitor performance after a product is approved. Some firms require formal review of complex products for a specific period of time so that the firm can assess their performance and determine whether product limitations are being met and whether market conditions have altered the risks associated with each product. FINRA believes that firms should also conduct periodic reviews to ensure that recommendations of complex products are only being made by authorized persons.

Training of Registered Representatives

Registered representatives who recommend complex products must understand the features and risks associated with those products. For example, FINRA suggests that a representative who recommends structured products with embedded options and derivatives should possess a sophisticated understanding of the payoff structure, any limit on upside potential, and the risks to investors that the payoff structure presents. FINRA further believes that representatives should be competent to develop a payoff diagram of a structured product and its embedded features and recognize that such a product typically can be decomposed into bond and derivative parts. According to FINRA, a representative should understand such features as the characteristics of the reference asset, including its historic performance and volatility and its correlation with specific asset classes, any interrelationship between multiple reference assets, the likelihood that the complex product may be called by the issuer, and the extent and limitations of any principal protection.

Customer Sophistication, Disclosures, and Understanding of Products

FINRA's suitability rule requires members to consider, among other factors, a customer's investment experience and risk tolerance when recommending a securities transaction or investment strategy. In recommending complex products, FINRA encourages firms to adopt the approach mandated for options trading accounts, which requires that a registered representative have a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the complex product.

Some firms make approval of complex products contingent upon investment concentration limitations or limitations on the type of investors to whom the product may be sold. Some firms prequalify retail investors through specialized investor qualification agreements that explain the product features and risk in plain English and include an attestation that the customer has read the materials provided, understands the risks, and wants to invest in the product. FINRA believes that the agreement cannot mitigate the responsibility of the firm and the registered representative to conduct a thorough, customer-specific suitability analysis.

FINRA notes that firms should take reasonable steps to ensure that representatives who recommend principal protected products understand the limitations of such protection and that the protection will not alone make a product suitable for all customers. FINRA suggests that firms should consider requiring some level of supervision by a specially qualified supervisor of these recommended transactions. FINRA also believes that firms should consider prohibiting recommendations of some complex products to retail investors whose accounts have not been approved for options trading, particularly the recommendation of complex products with embedded options or derivatives. FINRA notes that firms that permit the recommendation of complex products to retail investors whose accounts have not been approved for options trading should develop procedures to ensure suitability and should be prepared to demonstrate the basis for allowing the recommendation of complex products to such investors.

FINRA encourages members that recommend complex products to discuss with retail customers the features of a product, how it is expected to perform under different market conditions, the risks and the possible benefits, and the costs of the product. Representatives should discuss the scenarios in which the product may perform poorly and consider whether, after this discussion, the retail customer seems to understand the basic features of the product, such as the fundamental payout structure and the nature of underlying collateral or a reference index or asset. Representatives should consider whether less complex or costly products could achieve the same objectives for their customers.

Summary

FINRA cautions members that the recommendation of complex products to retail investors should only be made after implementation of heightened supervisory and compliance procedures. FINRA suggests that members should rigorously monitor these procedures and the sale of complex products in a manner reasonably designed to ensure that each product is recommended only to customers that understand the essential features of the products and for whom the products are suitable.

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