New Product Approvals

December 12, 2013
Overview
Critiques of “Complex” Products

- Especially following the financial crisis, regulators and the popular press have become increasingly skeptical about financial products that are viewed as the result of “financial engineering” or significant “structuring.”

- A number of concerns are raised repeatedly, including the following:
  - Do investors understand the products?
  - Are these products suitable for retail investors?
  - Do these products serve a function, or simply “repackage” otherwise available assets at a cost?
  - Are there embedded costs that are not well understood by investors?
  - Are there conflicts of interest inherent in the structuring and sales process?
FINRA Enforcement Actions

• FINRA disciplinary actions allege:
  • Failure to supervise
    • Inadequate systems
    • Inadequate training
  • Unsuitable sales
    • Across the board
    • Particular horror stories — elderly or unsophisticated customers
  • False or misleading disclosures
Summary timeline/recap

- NASD on Selling Non-Conventional Investments (3-71, Nov. 2003)
- NASD on New Products (5-26, April 2005)
- NASD on Structured Products (5-59, Sept. 2005)
- FINRA on Leveraged and Inverse ETFs (9-31, June 2009)
- FINRA on PPNs (9-73, Dec. 2009)
- FINRA on RevCons (10-09, Feb. 2010)
- FINRA on Commodity Futures-Linked Securities (10-51, Oct. 2010)
- FINRA sweep on RevCons (March 2011)
- FINRA actions (HR Block, Ferris Baker, Santander, UBS Financial Services)
- SEC/FINRA Investor Education Release (July 2011)
Summary timeline/recap (cont’d)

• FINRA Communications Release (July 2011, finalized in 2012)
• SEC OCIE Sweep (July 2011)
• Lehman decision (Southern District of NY)
• New Hampshire and other states
• SR – FINRA 2010-39 – Changes to the Know Your Customer Rule (Rule 2090) and the Suitability (Rule 2111)
• FINRA on Complex Products (12-03, Jan. 2012)
• SEC “sweep” letter (April 2012)
Focus on Suitability
Suitability

• Revised suitability standards became effective in October 2011.
• FINRA Rule 2111: A member must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer in response to the member’s reasonable efforts to obtain information concerning the customer’s age, other investments financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the member considers to be reasonable in making recommendations.)
• There are three main suitability obligations under Rule 2111:
  • “Reasonable-basis obligation” requires a member to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors.
Suitability (cont’d)

- “Customer-specific obligation” requires that a member have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer’s investment profile.
- “Quantitative suitability” requires a member to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer’s profile.
- A significantly less rigid standard applies with respect to “institutional accounts.”
- Standards likely to change in connection with Dodd-Frank and related efforts by the SEC and FINRA.
Suitability (cont’d)

• In its Notices to Members, FINRA has consistently emphasized the broker-dealer’s suitability obligation—from the product design and product approval process (“new product” approval) to post-sales review.
  
  • Notice 12-03 states that the reasonable basis suitability duty “includes reasonable diligence to understand the nature of the transaction or investment strategy” and that “reasonable diligence must provide the representative “with an understanding of the risk and rewards … [that] should be informed by an analysis of likely product performance in a wide range of normal and extreme market actions.” FINRA adds that “[t]he lack of such an understanding when making the recommendation could violate the suitability rule.”
  
  • The product manufacturer is best positioned to carry out the reasonable basis suitability analysis, since the manufacturer generates the product idea, designs the product features, stress tests and models the product, and is responsible for the disclosures regarding the product

- Notice provides FINRA’s observations from its recent examinations.
- Discusses practices which it deemed effective.
- “Adopting practices discussed in this Notice will not ensure rule compliance or result in a safe harbor, but we believe they are positive steps in building a strong compliance environment.”
- Results categorized to some extent according to:
  - Reasonable basis suitability.
  - Customer specific suitability.
  - Quantitative suitability.
• Reasonable-Basis Suitability:
  • Even smaller firms established investment committees to vet complex products, and whether they satisfied the reasonable-basis suitability standard.
  • Internal posting of due diligence of products, which may be used by representatives to recommend products.
  • Training for representatives before they may engage in the sale of an approved product, including testing.
  • Update representatives as to any new information relating to the product.
• Customer-Specific Suitability
  • Firms made necessary technological changes and process changes to capture the additional customer profile data required under the new rules.
  • Flagging accounts that did not have full information, and potentially avoided recommended transactions with those investors.
  • More granular analysis of investor characteristics and risk tolerance; flagging vulnerable investors.
  • Targeted education discussions with vulnerable customers, including more frequent portfolio assessments.

• Quantitative Suitability
  • Most firms monitor customer accounts for churning and excessive trading.
  • Updating surveillance and monitoring by incorporating aspects of the rule changes, such as additional customer profile information, into data and exception reports.
  • FINRA believes that firms should evaluate whether their compensation arrangements could incent a sales person to engage in excessive trading, or to make unsuitable recommendations.
Complex Products
FINRA Regulatory Notice 12-03, January 2012

• Heightened supervision of complex products

• What is 12-03?
  • Guidance to firms about supervision.
  • An attempt to identify characteristics that render a product “complex” – largely focused on structured products.

• 12-03 focuses on activities of other regulators
  • SEC (U.S.)
  • European and Asian Regulators
What Is Complex?

• 12-03 doesn’t attempt to definitively answer that question.

• “Any product with multiple features that affect its investment returns differently under various scenarios is potentially complex. 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

• Products that include an embedded derivative component “that may be difficult to understand”:
  • Reference asset, the performance of which is not readily available to investors. (the CMS rate)
  • Notes that provide for different stated returns throughout the lifetime of the product. (e.g., steepener notes with a high teaser rate.)
  • Range accrual notes.
  • Notes where loss is possible, but no participation in gains. (RevCons)
  • Notes with a “knock in” or “knock out” feature, where a change in the performance of the reference asset can have a disproportionate impact on the repayment of capital or on the payment of return.
  • Products with contingencies in gains or losses, particularly those that depend upon multiple mechanisms, such a range accrual note with two or more reference assets.
FINRA Regulatory Notice 12-03, January 2012
Examples of Complex Products (cont’d)

• Notes with “worst-of” features.
• Investments tied to the performance of markets that may not be well understood by many investors, such as volatility.
• Products with principal protection that is conditional or partial, or that can be withdrawn under certain circumstances.
• Product structures that can lead to performance that is significantly different from what an investor may expect, such as products with leveraged returns that are reset daily (e.g., leveraged ETFs)
• Products with complicated limits or formulas for the calculation of investor gains.
Firm must perform a “reasonable basis” suitability determination: a transaction or investment strategy is suitable for at least some investors.

To do so, the firm must perform reasonable diligence to understand the nature of the transaction, as well as the potential risks and rewards.

This understanding should be informed by an analysis of likely product performance in a wide range of normal and extreme market actions. The lack of such an understanding when making the recommendation could violate the suitability rule.

Firms should 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. The procedures should ensure that the right questions are answered before a complex product is recommended to retail investors.
Questions for the New Product

• For whom is this product intended? Limited or general retail distribution, and, if limited, how will it be controlled?
• To whom should this product not be offered?
• What is the investment objective and is that 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 same objectives?
• 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 benefits not occur?
• What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks?
Questions for the New Product (cont’d)

• How will the firm and registered representatives be compensated?
• Will the offering of the product create any conflicts of interest between the customer and any part of the firm? If so, how will those conflicts be addressed?
  • Discussed in more detail in FINRA’s October 2013 report re conflicts of interest.
  • Embedded conflicts of interest:
    • Affiliated calculation agent.
    • Hedging disruption events.
    • Proprietary indices and discretion.
• Are there 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 for the product?
• How liquid is the product?
FINRA Regulatory Notice 12-03, January 2012
Post-Approval Review

• Firm should periodically reassess complex products a firm offers to determine whether their performance and risk profile remain consistent with the manner in which the firm is selling them.
• Firms also should consider developing procedures to monitor how the products performed after the firm approved them.
• Firms also should conduct periodic reviews to ensure that only associated persons who are authorized to recommend complex products to retail customers are doing so.
Registered representatives who recommend complex products must understand their features and risks.

Registered representatives who recommend structured products should possess a “sophisticated understanding” of the payoff structure and risks.

The registered representative should be able to develop a payoff diagram of a structured product to facilitate the analysis of its embedded features and recognize that such a product typically consists of a bond and derivative parts.

The registered representative also 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, and the extent and limitations of any principal protection.

The registered representative should be adequately trained to understand not only the manner in which a complex product is expected to perform in normal market conditions, but the risks associated with the product.
FINRA Regulatory Notice 12-03, January 2012
Consideration of a Customer’s Financial Sophistication

• 12-03 encourages firms to adopt the approach mandated for options trading accounts: would require 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 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.

• Firms also should consider prohibiting their sales force from recommending the purchase 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.
  • Similar text to 05-59.
Firms that permit the recommendation of complex products to retail investors whose accounts have not been approved for options trading should:

- Develop other comparable procedures designed to ensure that their sales force does not solicit retail customers for whom complex products are unsuitable.
- Be prepared to demonstrate the basis for allowing their sales force to recommend complex products to retail investors with accounts that are not approved for options trading.

Approving an account for the purchase of complex products is not a substitute for a thorough suitability analysis.
The registered representative who intends to recommend a complex product should discuss with the customer:

- The features of the product.
- How it is expected to perform under different market conditions.
- The risks and the possible benefits, the costs of the product.
- The scenarios in which the product may perform poorly.

The registered representative should consider whether, after this discussion, the retail customer seems to understand the basic features of the product.
FINRA Regulatory Notice 12-03, January 2012

• Consideration of whether less complex or costly products could achieve the same objectives for the customer
  • Registered representatives should consider whether less complex or costly products could achieve the same objectives for their customers.
  • For example, registered representatives should compare a structured product with embedded options to the same strategy through multiple financial instruments on the open market, even with any possible advantages of purchasing a single product.
Considerations for Approval Committees
Suitability assessments

- The reasonable basis suitability assessment is essential in discharging the product provider’s obligations
- Any assessment should take into account:
  - The generation of the product idea
  - The target market for the product, or the product’s intended purpose
  - The design of the product features
  - The types of conditions under which the product performance has been evaluated (looking at hypotheticals, at stress-testing, etc.)
  - The overall risks and rewards of the product
  - The financial and market risk associated with the product
  - Any legal risks
  - The complexity of the product
  - Reputational risks
Suitability assessments

• In evaluating a potential new product, the Committee will want to consider whether:
  • Competitors offer similar product
  • The product pay-out is particularly complex
  • The product pay-out renders the product unsuitable for certain types of investors
  • The product incorporates leverage
  • The product references an asset class that is well understood, or an asset class that may present particular risks or may be less well understood by retail investors
  • The product references a new asset class, or a proprietary index
  • The pay-out or contingencies render the product complex
  • There are novel legal issues or novel tax issues
  • There are particular disclosure concerns
  • The format or “wrapper” in which the investment will be packaged
Suitability assessment

- Some market participants categorize or “group” products based on particular attributes and may subject certain products to heightened scrutiny—for example, some market participants identify the following products as requiring closer consideration:
  - Structured products with downside risk (revcons)
  - Structured products with complex underlyings (like volatility or a proprietary index) or complex pay-outs
  - Structured products with no certainty of a coupon for the full tenor (like zero coupons, teasers, or knock-out coupons)
  - Long tenor structures (usually anything over 10 years)
  - Credit-linked products
Suitability assessment

- Other market participants have formulated a “matrix” approach and identified various characteristics that a Committee should consider in connection with a suitability review. Some “benchmark” their products against other products offered by competitors.
Four Quadrants of Note and Index Complexity

- **B1**
  - Note Complexity
    - Complex strategy (e.g. market-neutral, momentum, carry, negative serial correlation, etc.)
    - Frequent rebalancing
    - Multiple indexing levels
    - Actively managed
    - Broad asset class
    - High embedded leverage
    - Volatility control
  - Index Complexity
    - Downside protection (principal protection, buffer, etc.)
    - High minimum purchase amount (> $10,000)
    - High liquidity (e.g., listed, registered, allows for redemption, etc.)
    - Fixed coupon

- **C**
  - Note Complexity
    - Downside leverage
    - Low minimum purchase amount (< $1,000)
    - Low liquidity
  - Index Complexity
    - Variable or zero coupon
    - Upside limitation (e.g., return cap, return hurdle, etc.)
    - Unfavorable tax treatment

- **B2**
  - Note Complexity
    - Low embedded leverage
    - No volatility control
  - Index Complexity
    - Infrequent rebalancing
    - Direct asset exposure
    - Not actively managed
    - Specific asset or asset class

- **A**
  - Note Complexity
    - Broad asset class
    - High embedded leverage
    - Volatility control
  - Index Complexity
    - Downside leverage
    - Low minimum purchase amount (< $1,000)
    - Low liquidity
    - Variable or zero coupon
    - Upside limitation (e.g., return cap, return hurdle, etc.)
    - Unfavorable tax treatment
Suitability assessment

• Here are some considerations that may inform the Committee’s analysis as it reviews a potential new product

• Describe the product in general, including the maximum term to maturity.
  • *Products with a longer term to maturity may be perceived as riskier, or more difficult for a potential investor to evaluate*

• Provide an example of the product under current market conditions. What assumptions underlie the product? How is the product expected to perform in different economic scenarios?
  • *The Committee should consider the likely pay-out under normal scenarios, as well as under stress scenarios. FINRA will consider whether the product is “designed to fail” or whether it offers a value proposition only under certain limited scenarios.*
Suitability assessment

• What is the product’s investment objective? Is that investment objective reasonable in relation to the product’s characteristics? Does this product provide market access, or exposure to a particular investment strategy, or otherwise add to the firm’s current product offerings?

  • FINRA will consider the fundamental objective of the product (is it enhanced yield? Market access? etc.) Is the new product priced such that the potential yield is an appropriate rate of return in relation to the volatility of the reference asset based on comparable and similar investments, in terms of structure, volatility and risk in the market. For example, similar structured products based on reference assets that possess substantially similar volatility characteristics, but which offer materially different rates of return, should call into question whether the instrument with the lower yield meets the reasonable basis suitability standard.
Suitability assessment

• How would you describe the target market for the product? Are there particular types of accounts/investors for which the product may not be appropriate?
  
  • Is it a retail product? High net worth/private bank client product? What are the minimum denominations? Is there a minimum purchase requirement? Is it intended for investors that seek higher yield? For investors that do not need current income?
  
  • Whether the economic exposure provided by the product is appropriate for the relevant class of investor, both in terms of risk and “type” of exposure.
    
    • For example, a product providing heavily leveraged downside exposure to a particular reference asset may not be suitable for retail investors. In addition, exposure to certain types of complex “hidden assets” (for example, “skew” and “smile”) may also not be appropriate for retail investors; even if the risk of the product is not particularly high.
Suitability assessment

• When selling a product into the retail market, you should consider the types of investments typically held by retail investors and whether the proposed new product would be an appropriate component of such an investor’s investment mix;
• whether the new product can be explained in a manner that can be reasonably expected to be understood by the relevant class of investor, and where investors in such class can be reasonably expected to be capable of evaluating the risks; and
• whether the reference asset could be sold directly to the relevant class of investor. As a general rule, if the reference asset could not be sold directly, a structured product on such reference asset should also not be sold.
Suitability assessment

• Does the product incorporate leverage? Incorporate any algorithmic models, or quantitative strategies? What are the elements, if any, of the product that might be deemed “complex”? Could a less complex structured product be developed that could achieve the same objective?

  • FINRA assumes that products that incorporate leverage are “riskier” and more difficult for a retail investor to understand and evaluate. Leverage may magnify losses in unpredictable ways. Similarly, FINRA assumes that products that incorporate a proprietary model or quantitative strategies are more complex, even if the pay-out is simple. FINRA Notice 12-03 provides examples of the types of products that may be complex.

  • The Committee may consider asking additional questions or formulating an additional questionnaire for products that reference an index, which may include the following considerations: Does the index use a complex strategy (e.g., market-neutral, momentum, carry, negative serial correlation, etc.)? Does the index have high embedded leverage? Is there frequent rebalancing?
Suitability assessment

• Are there multiple indexing levels? Is the index actively managed? Does the index track a broad asset class? Does the index have a volatility control? Does the note have downside leverage? Does the note have a low minimum purchase amount (<$1,000)? Does the note have an upside limitation (e.g., return cap, return hurdle, etc.)?

• What market or performance factors determine the investor’s return? Under what scenarios would principal protection, enhanced yield, contingent protection, or other presumed benefits not be realized?

• FINRA views products that incorporate “contingencies” as more challenging for retail investors to understand. Retail investors may not understand how contingencies will affect their potential investment or their return. Products with contingencies will require more detailed disclosures; disclosures must be clear. There is also a higher risk that distributors may not understand or being able to explain the contingencies.
Suitability assessment

• How will the distributor be compensated for offering the product (i.e., what are the associated fees paid to third parties)? Is there anything different about the fees that will be paid in connection with the distribution of this product compared to other products?

  • FINRA is concerned that a “structured product” contains embedded fees and that the “packaging” may obscure inappropriate fees or mark-ups. In addition, FINRA is concerned that the compensation paid to product manufacturers or distributors may motivate them to sell a structured product in favor of a simpler product.

• Will the offering of the product create any conflicts of interest between the investor and any part of the firm or its affiliates? If so, how will those conflicts be addressed?

  • FINRA has conducted a “conflicts of interest” sweep and has noted that structured products may involve conflicts of interest (whether in connection with the product manufacturing by the issuer’s affiliated broker-dealer; the hedging arrangements between the affiliated broker-dealer and the issuer; the index creation; any calculation agent function; distribution through private banking or advisory channels).
Recommendations

• The Committee must consider implementing a variety of tools, such as:
  • Requiring higher minimum denominations
  • Requiring minimum purchase requirements
  • Imposing restrictions on the types of potential investors
  • Limiting sales to advised channels
  • Only selling the product through particular distributors that are better suited to handle complex products
  • Providing additional training to the distributors
    • Requiring special training for personnel
  • Granting only conditional approval for a limited period of time, subject to certain requirements
  • Mandating post-approval review within a specified period of time
What Can Go Wrong – FINRA Enforcement Actions
FINRA Enforcement Actions Regarding Complex Products, Generally

• FINRA disciplinary actions allege:
  • Failure to supervise
    • Inadequate systems
    • Inadequate training
  • Unsuitable sales
    • Across the board
    • Particular horror stories — elderly or unsophisticated customers
  • False or misleading disclosures

- FINRA fined Ferris, Baker Watts LLC $500,000 for inadequate supervision of sales of reverse convertible notes to retail customers.
- Also found unsuitable sales of reverse convertibles to 57 accounts held by elderly customers who were at least 85 years old and customers with a modest net worth. The firm was ordered to pay nearly $190,000 in restitution.
- Firm failed to provide sufficient guidance to its brokers and supervising managers on how to assess suitability in connection with their brokers' recommendations of reverse convertibles.
- Additionally, the firm did not have a system to effectively monitor customer accounts for potential over-concentrations in reverse convertibles. The firm also failed to detect and respond to indications of potential over-concentration in reverse convertibles.
FINRA Reverse Convertible Actions – H&R Block (Feb. 2010)

- Firm used an automated surveillance system for suitability review of securities transactions and to monitor customer accounts for potentially unsuitable positions and activity.
- However, the firm's system 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.
- Horror stories
  - Recommended that a retired couple in their 80s, with a moderate risk tolerance and a long-term growth objective, invest more than $100,000 in an RCN -- over 85 percent of their account value and more than half of their liquid net worth. Loss of over $88,000.
  - Recommended that a 36-year-old with no investment experience, moderate risk tolerance and a long-term growth objective, invest $95,000 in an RCN. Loss of $80,000.
- 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 Reverse Convertible Actions – Santander Securities (April 2011)

• April 2011, FINRA fined Santander Securities
• Issues raised by FINRA:
  • Unsuitable sales
    • Citing sales to retirees
  • No process for reviewing and approving particular products before sales
  • Inadequate supervision of structured products sales
    • Citing a lack of training, a lack of suitability guidance
  • Concentrated positions in reverse convertibles
    • No detection or screening system
  • Inadequate supervision of recommendations and sales using loans from firm’s banking affiliate, to capture the spread;
    • Dramatically increased exposure to risk
Reminders for Broker-Dealers

• Confirm that an appropriate new product approval process is in place, that it is determined to be effective, and that post-approval reviews are conducted

• Ensure that appropriate suitability guidelines are in place and adhered to by representatives/advisers
  • Consider conducting an inventory of products offered by broker-dealer: which products are “complex”?
  • Consider creating specific guidelines for “complex products”
  • Consider limiting sales of certain “complex products” to specially trained sales force and if distributors are used, then ensure distributors are adequately trained.

• Assess process to vet concentration issues
  • Concentration by product type
Reminders for Broker-Dealers (cont’d)

• Review policies and procedures for structured products sales
• Ensure account opening procedures are followed
• Conduct reviews of all internal and external structured products materials
• Ensure that appropriate training is mandated
  • Special training is required for “complex products”
• Review offering procedures to ensure proper filings are made
• Review process for secondary trades