

Are Structured Products Suitable for Retail Investors?

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Equity-linked notes - a type of structured product - are securities issued by brokerage firms and traded in the secondary markets like shares of common stock. These investments offer part of the upside from owning stocks but limit nominal losses if held until maturity. Once sold only to sophisticated investors, structured products are increasingly being sold to unsophisticated retail investors. Equity-linked notes are difficult to evaluate and monitor, have high hidden costs and are illiquid. They are therefore virtually never suitable for unsophisticated investors.

I. Introduction

Sales of structured products have soared in recent years as brokerage firms have found a retail market for products once sold only to sophisticated investors. According to the Structured Products Association – a trade group representing issuers and vendors – almost \$50 billion of structured products were sold in 2005.²

Structured products can be too complex and opaque for retail investors and registered representatives to understand. This complexity and opaqueness allows structured products to survive in the marketplace despite their marked inferiority to traditional portfolios of stocks and bonds. The NASD has taken notice.

In the current investment environment, investors and brokers are increasingly turning to alternatives to conventional equity and fixed-income investments in search of higher returns or yields. Such products, including ... structured notes ... are often complex or have unique features that may not be fully understood by the retail customers to whom they are frequently offered, or even by the brokers who recommend them. Some appear to offer benefits to investors that are already available in the market in the form of less risky, less complicated, or less costly products, prompting concerns about suitability and potential conflicts of interest. [Notice to Members 05-26, page 2.]

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² See “An Arcane Investment Hits Main Street: Wall Street Pushes Complex 'Structured Products,' Long Aimed at Institutions, to Individuals” *Wall Street Journal* June 21, 2006, D1 and “Guaranteed to Go Up” *Forbes* November 27, 2006 p. 79-80.

The focus of this paper is a particular type of structured product - equity-linked notes – but our analysis could be readily extended to other types of structured products. Equity-linked notes are not stocks, bonds or derivatives – they are hybrid securities. Equity-linked notes are listed on the AMEX or the NASDAQ and trade, albeit thinly, in the secondary market. At maturity, these securities repay the offering price and perhaps some additional amount determined by a complicated function of the change in the value of the security or index since the offering date. The payoffs to equity-linked notes can be replicated with combinations of stocks, bonds, options and futures.

Brokerage firms issuing structured products under evocative brand names for sale to retail investors include Bank of America, Bear Stearns, CIBC, Citigroup, Goldman Sachs, JP Morgan, Lehman Brothers, Merrill Lynch, Morgan Stanley, UBS, Wachovia and Wells Fargo. Brokerage firms make money issuing equity-linked notes because the product they put together is worth significantly less than the offering price. In addition, the managers of the initial offering receive an underwriting spread or selling concession, and trading in the secondary market generates further retail commissions.

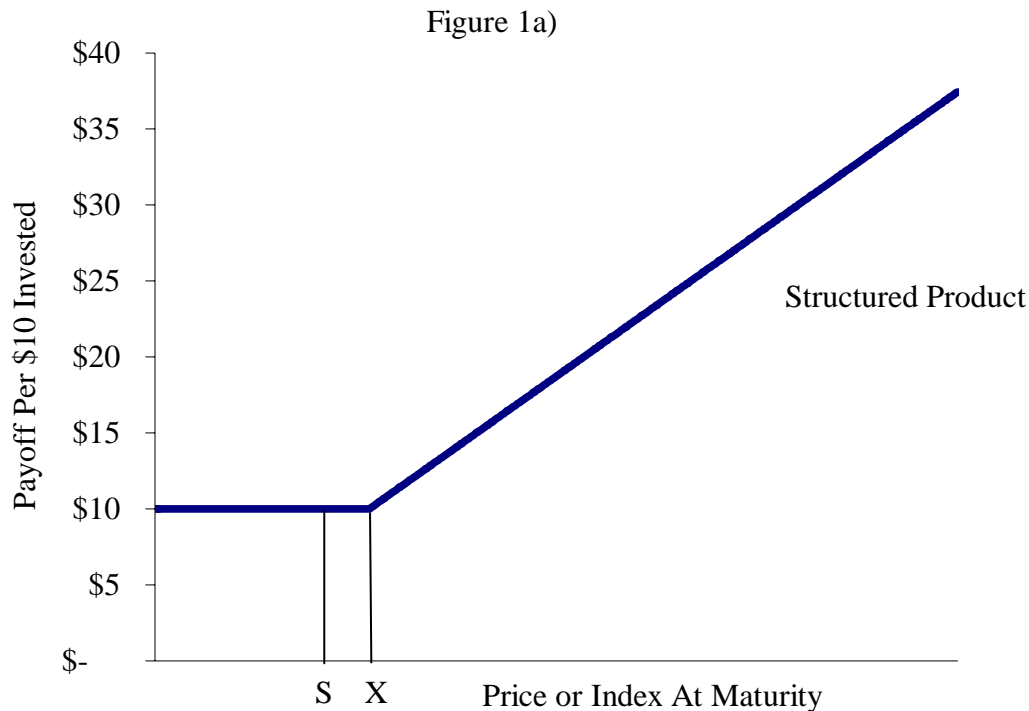
In what follows, we explain the basic features of equity-linked notes and illustrate the notes with a few real world examples. We then review the NASD's Notices to Members on the sale of structured products. We observe that the more complex and difficult to evaluate these products are, the greater the hidden costs investors pay relative to readily available, more transparent investments.

II. The Basic Equity-Linked Note Structure

Retail-oriented equity-linked notes have maturities of from one to ten years and typically do not pay interim interest or dividend distributions. The securities return the original issue price at maturity plus an additional amount depending on the value of the underlying stock or stock index at maturity.³

³ The issue price is only 70% or 80% or less of what the US Treasury guarantees it will return on purely risk free securities held for 5 to 10 years and so this return of principal guarantee should not be oversold.

Figure 1a) illustrates stylized payoffs at maturity to a stylized principal-protected equity-linked note.



The note is issued at an offering price of \$10 when the stock price or stock index level is “S”. At maturity, the note returns the \$10 issue price plus a portion of the increase in the index beyond some threshold “X.”⁴ This threshold, X, is determined by multiplying the initial index level, S, by the cumulative impact of “clipping” the portfolio each year by the amount of the spread. For example, if we assume the annual spread equals is 2%, X is equal to 122% of S.⁵ If the index level is less than X at maturity the holder receives \$10. If the stock price or index level is greater than X at maturity, the holder receives a fraction of the additional gains beyond X. Thus in exchange for the

The additional return paid on some equity-linked notes is a function not only of the increase in the value of the stock or stock index between the issue date and maturity but may also be a function of the particular evolution of the stock price or index level over that time period.

⁴ Some equity-linked notes like the Intel-linked TARGETS[®] below do not guarantee return of principal.

⁵ $X = (1 - 0.02)^{-10} \times S = 1.22 \times S$.

promise that an investor will receive the original offering price, the investor gives up the dividends paid on the underlying stocks, all of the first 15% or 20% in capital gains and 15% or 20% of any gains beyond that.

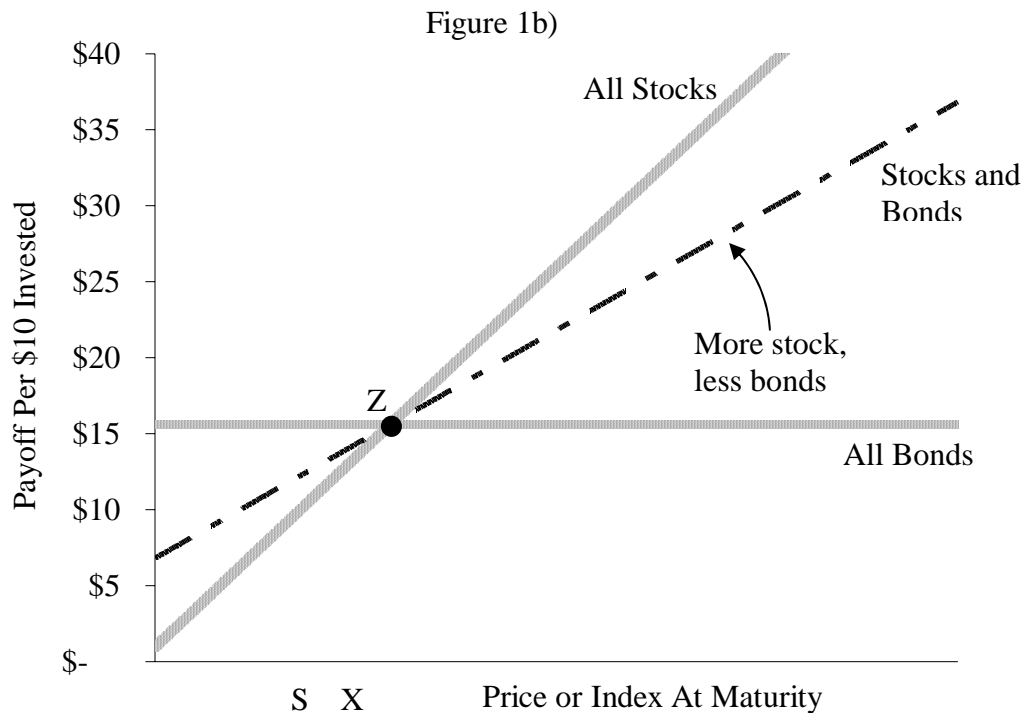
Those familiar with options diagrams will recognize that Figure 1a) illustrates the payoffs at maturity to a portfolio comprised of a call option with a strike price of X on the underlying security and a \$10 face-value zero-coupon Treasury security maturing when the call option expires.⁶ This is a relatively easy portfolio to value and allows us to directly determine whether a simple structured product like the illustrated note is over-priced relative to alternative investments. Later we report valuations of real world examples of structured products using this option-based approach.

An alternative way to evaluate a structured product is to compare it to a simple portfolio stocks and bonds as suggested by the NASD in the quote at the beginning of the paper. Figure 1b) and Figure 1c) together illustrate this comparison.

Terminal values of portfolios of stocks and bonds are plotted in Figure 1b) for various levels of the underlying stock price or index. An investor who invests \$10 in 10-year, zero-coupon Treasury bonds yielding 4.5% per year will have bonds worth \$15.61 at maturity regardless of the stock price or index level.⁷ An investor who buys \$10 worth of stock and holds it for 10 years will own a stock position whose value will be a linear function of the stock price or index level at maturity.

⁶ Figure 1a) also illustrates the payoffs at maturity to a portfolio comprised of the underlying stock and a put option with a strike price of X and a short position of (X-\$10) face-value zero-coupon Treasury security maturing when the put (and call) option expires.

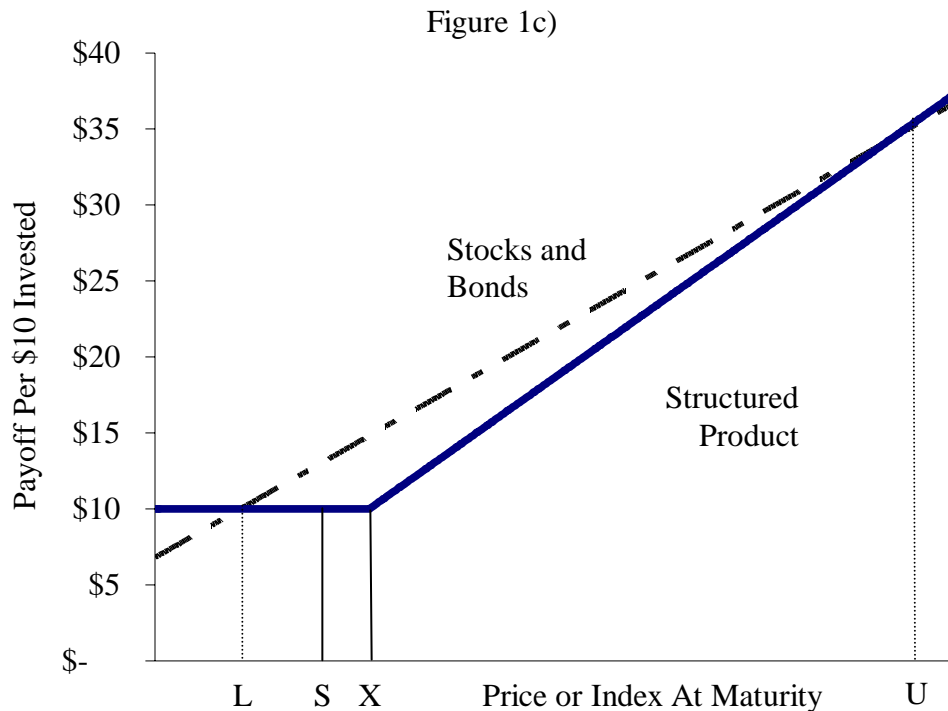
⁷ $\$15.61 = \$10 * (1 + 4.5\%/2)^{2*10}$. We assume a 1.7% annual dividend yield on the average of the initial offering price and the offering price adjusted for the increase over the term in the index.



The payoffs at maturity to mixed portfolios of stocks and bonds are illustrated by straight lines rotated through the point, Z, where the all stock portfolio and the all bond portfolios' lines intersect. Portfolios with larger stocks allocations are represented by steeper lines reflecting that the value at maturity of more stock-laden portfolios is more sensitive to the level of the stock index than portfolios with less stock.

Figure 1c) combines the payoffs to the structured product from Figure 1a) with the payoffs to the mixed stock and bond portfolio from Figure 1b) and suggests a way to evaluate the structured product. For this illustration, we assume the stock and bond portfolio starts with 60% invested in stock and 40% invested in bonds and is *never* rebalanced. The structured product's \$10 minimum value is greater than the value of the stocks and bonds at maturity if the stock index is below L. The structured product is also worth more than the mixed stock and bond portfolio at index levels above U because the structured product benefits from its greater sensitivity to stocks at very high levels of the

stock index. For index levels between L (lower bound) and U (upper bound), the mixed portfolio of stocks and bonds is worth more at maturity than the structured product.



The lower bound, L, in our example is at approximately 50% of the initial index level so the stock index would have to decline approximately 50% over the 10-year term of the structured product for it to be worth more than the mixed portfolio of stocks and bonds. The upper bound, U, in Figure 1c) is at approximately 420% of the initial index level so the stock index would have to increase approximately 320% over the 10-year term of the structured product for it to be worth more than the stocks and bonds. While declines of more than 50% and increases of more than 320% over 10 years are not impossible, they are extremely unlikely.

A higher initial allocation to stocks rotates the dotted line counter-clockwise through Z, making it steeper and shifting both L and U to the right. A lower initial allocation to stocks rotates the dotted line clockwise through Z, making it flatter and

shifting both L and U to the left. Thus the higher the initial allocation to stocks, everything else held constant, the greater the relative value of the downside protection but the smaller the potential upside advantage the structured product has over the stock and bond portfolio at very high stock market levels. The allocation to stocks and bonds in comparisons portfolios is determined to maximize the value of the stock and bond portfolio relative to the equity-linked note. This allows us to compare the equity-linked note to alternatives *already available in the market in the form of less risky, less complicated, or less costly products* as required by the NASD.⁸

Higher embedded costs in the structured product shifts X to the right and/or makes the upward sloping portion of the structured product's payoff line flatter, shifting U to the right. Lower embedded costs in the structured product shifts X to the left and/or makes the upward sloping portion of the structured product's payoff line steeper, shifting U to the left. As we will demonstrate next, structured products' costs are high and the more complex - and therefore the more opaque - the structure, the higher the costs.

Even though the stock and bond portfolio illustrated above is *never* rebalanced, the mixed portfolio of stocks and bonds will be worth more at maturity than the structured product almost all the time. The buy-it-and-forget-about-it portfolios are worth more at maturity than investments in the actual equity-linked notes at issuance analyzed next 94% to 97% of the time. If we assume that the comparison portfolio is rebalanced periodically, the simple stock and bond portfolios are worth more at maturity than the notes **100%** of the time.

⁸ Notice to Members 05-26, page 2.

III. Two Basic Equity-Linked Note Structures, Three Examples.

Some equity-linked notes provide “principal protection” in exchange for limited participation in stock market gains. The securities return the original issue price at maturity plus an additional amount depending on the value of the underlying stock or stock index at maturity.⁹ These notes look a lot like combinations of bonds and call options on the stock or stock index linked to the notes. Other equity-linked notes potentially pay “enhanced yield” compared to conventional debt but expose investors to the downside in the stock or stock index linked to the notes. These notes are combinations of bonds and naked short put options.

To illustrate structured products we examine equity-linked notes from Merrill Lynch, JP Morgan and Citigroup.

A. Merrill Lynch’s S&P 500 Market Index Target-Term Securities - MITTS[®]

Merrill Lynch’s series of S&P 500 Market Index Target-Term Securities - MITTS[®] - are examples of principal-protected notes. One such note was issued on August 30, 2002 to mature on September 4, 2009 and trades on the AMEX under the ticker symbol MKP.

The notes were priced based on the S&P 500 closing level on August 29, 2002 of 917.80. The notes will pay \$10 plus a return equal to the percentage excess, if any, of 85.7% of the S&P 500 level at maturity over the initial 917.80 index level. Thus, if the S&P 500 closes below 1,070 on September 4, 2009 holders will just receive the \$10 initial offering price. If the S&P 500 closes above 1,070 on September 4, 2009, holders receive 85.7% of the difference between the ending S&P 500 level and 1,070 divided by

⁹ The issue price is only 70% or 80% or less of what the US Treasury guarantees it will return on purely risk free securities held for 5 to 10 years and so this return of principal guarantee should not be oversold. The additional return paid on some equity-linked notes is a function not only of the increase in the value of the stock or stock index between the issue date and maturity but may also be a function of the particular evolution of the stock price or index level over that time period.

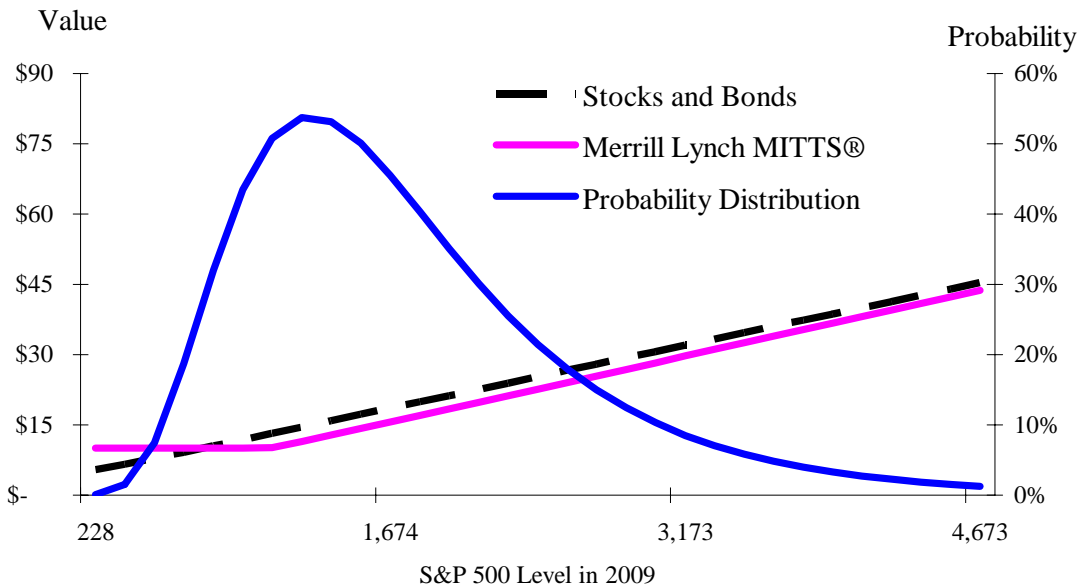
the 917.80 starting level. If, for example, the S&P 500 closes at 1,600 on September 4, 2009, holders will receive \$14.94 per note.¹⁰

Merrill Lynch's \$10 MITTS[®] maturing on September 4, 2009 provided \$8.80 worth of investment value at issuance for each \$10 invested. The difference, \$1.20 or 12.0%, is a good measure of the hidden costs investors paid at the offering to buy Merrill Lynch's notes. The expected value of the MITTS[®] note at maturity was \$17.43 but the expected value of the Treasury securities and stock portfolio when the MITTS[®] note matures was \$19.55. For every \$1 in expected value at maturity when the MITTS[®] note is superior to the Treasury securities and stock portfolio, investors give up \$44 in expected value at maturity when the MITTS[®] structured product is inferior to the Treasury securities and stock portfolio (index levels between 700 and 7,600 at maturity).

Figure 2 illustrates the results of Monte Carlo simulations comparing the MITTS[®] equity-linked note to a portfolio initially invested 75% in stocks and 25% risk-free Treasury bonds. The portfolio of Treasury securities and stocks is worth more than the MITTS[®] note for all levels of the S&P 500 on September 4, 2009 between 700 and 7,600. Based on realistic assumptions, we determined that the probability that the S&P 500 Index level on September 4, 2009 will be between 700 and 7,600 is 95%. That is, investors who bought the MITTS[®] note in the offering would be worse off 95% of the time at maturity than if they had invested in a simple buy-it-and-forget-about-it portfolio of stocks and bonds.

¹⁰ $\$14.94 = \$10 \times [1 + \{(0.857 \times 1,600 - 917.80) \div 917.80\}]$.

Figure 2
Merrill Lynch MITTS
and 25% Treasuries / 75% Stock



For simplicity, we assumed that the initial portfolio of stocks and bonds is never rebalanced during the full seven-year term. If instead we rebalance the portfolio periodically depending on changes in the S&P 500, the probability of the portfolio of stocks and bonds exceeding the value of Merrill Lynch's MITTS[®] September 4, 2009 increases to **100%**. Even very infrequent rebalancing based on crude rules of thumb increases the probability that the portfolio of stocks and bonds will exceed the value of Merrill Lynch's MITTS[®] at maturity to 99.5%. That is, investors who bought the MITTS[®] note at issuance are always worse off at maturity than if they had invested in a portfolio of stocks and bonds and rebalanced periodically.¹¹

¹¹ There is a close correspondence between equity-linked notes and equity-indexed annuities. In our prior research on equity-indexed annuities, we compared the value of the equity-indexed annuities at the end of surrender periods with simple buy-and-forget-about-it portfolios and found the equity-indexed annuities inferior more than 95% of the time. We are currently extending our equity-indexed annuities research to include periodic rebalancing and find, as herein, that simple comparison portfolios of stocks and bonds, periodically rebalanced, beat the high cost, complex investment essentially 100% of the time.

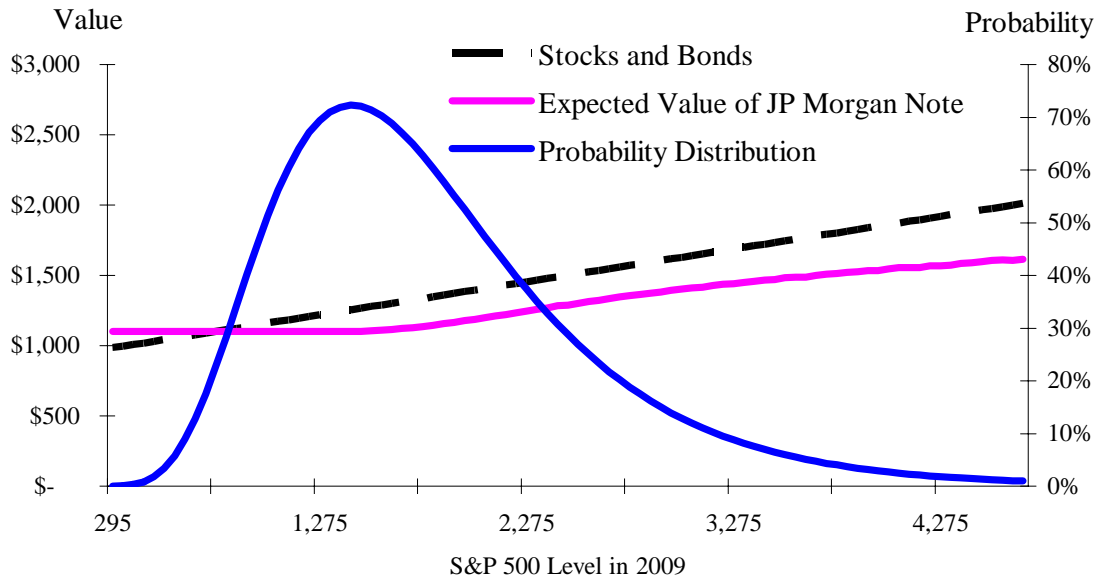
B. JP Morgan's July 7, 2009 Capped Quarterly Observation Notes

On June 22, 2004, JP Morgan issued Capped Quarterly Observation Notes linked to the S&P 500 maturing on July 7, 2009 at a \$1,000 offering price to trade on the AMEX under the ticker symbol JPL.G. Like the MITTS[®] analyzed above, JP Morgan's notes are principal-protected notes linked to the S&P 500 index but they are much more complicated.

The notes were priced based on the initial S&P 500 level of 1,134. At maturity, the notes will pay the greater of \$1,100 or \$1,000 plus a return which is a function of the sum of the 20 quarterly changes in the S&P 500 during the 5-year term. The individual quarterly returns to be added together are capped at 6%. By returning at least \$1,100 the issuer guarantees at least a 1.9% per year return but capping and not compounding the quarterly returns severely limits the upside potential from stock market gains. JP Morgan's Capped Quarterly Observation Notes is an extraordinarily complicated investment as it depends not only on the change in the value of the index over the life of the note but also on the pattern of the interim index level changes.

JP Morgan's Capped Quarterly Observation Notes provided investors \$882.80 worth of investment value per \$1,000 bond at issuance. The difference, \$111.20 or 11.1%, is a good measure of the hidden costs investors paid at the offering to buy JP Morgan's notes. The expected value of JP Morgan's structured note at maturity was \$1,183 but the expected value of the Treasury securities and stock portfolio at maturity was \$1,348. For every \$1 in expected value at maturity when the note is superior to the Treasury securities and stock portfolio (index levels below L or above U), investors give up \$191 in expected value at maturity when JP Morgan's note is inferior to the Treasury securities and stock portfolio.

Figure 3
JP Morgan Capped Quarterly Observation Notes
and 75% Treasuries / 25% Stock Portfolio



We compared the Capped Quarterly Observation Notes to a portfolio initially invested 25% in stocks and 75% in risk-free Treasury bonds without rebalancing using a Monte Carlo simulation. Figure 3 illustrates the results of our simulations. Because the value of JP Morgan's equity-linked note is a function of the quarterly returns over the note's 5-year term and not just the level of the index at maturity, we plot the average value of the note for each index level considering all the possible paths to arrive at that level. The portfolio of Treasury securities and stocks is worth more than the expected value of the JP Morgan note for all levels of the S&P 500 on July 7, 2009 above 775. Based on realistic assumptions, we determined that investors who bought the JP Morgan note at issuance would be worse off 97% of the time at maturity than if they had invested in a simple buy-it-and-forget-about-it portfolio of stocks and bonds.

As with the MITTS[®], incorporating rebalancing into the comparison makes JP Morgan's notes look even worse. Simple periodic rebalancing makes the stocks and bonds portfolio better than the JP Morgan note **100%** of the time.

C. Citigroup's February 15, 2008 Intel-Linked TARGETS[®]

Citigroup's Targeted Growth Enhanced Term Securities - TARGETS[®] are examples of enhanced-yield notes. On February 25, 2005 Citigroup issued TARGETS[®] linked to Intel's stock price maturing on February 15, 2008.¹² These notes were issued at a \$10 offering price and were listed on the AMEX under the ticker symbol TOI. The notes pay a 1.75% quarterly coupon but, unlike the Merrill Lynch and JP Morgan notes above, there is no guarantee that investors will get back their principal. The maturity payment is a function of the sum of the monthly returns to Intel with a 4.5% monthly cap and a -12% monthly floor.

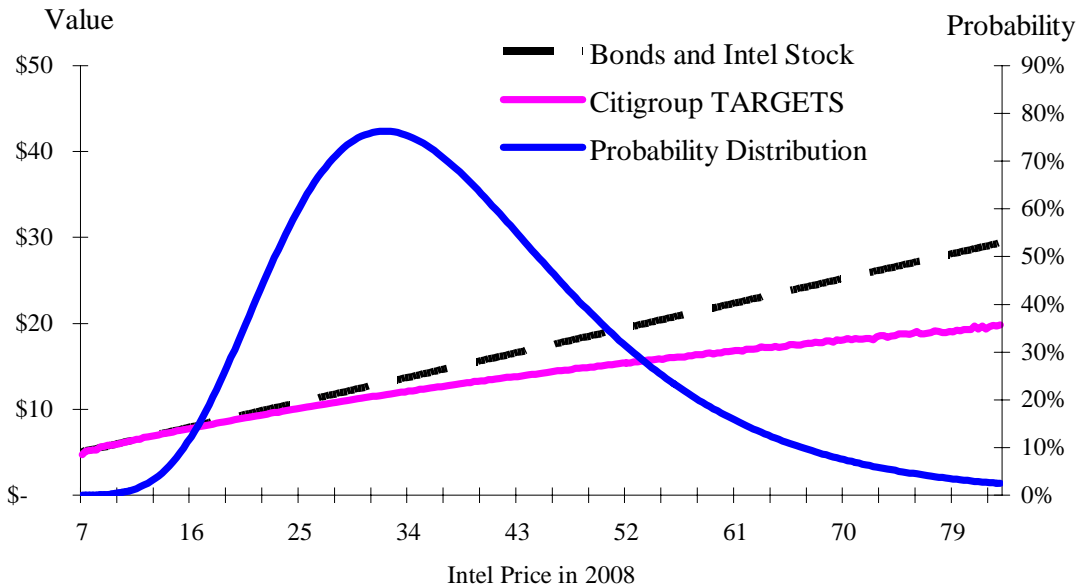
Citigroup's TARGETS[®] provided investors \$8.28 worth of investment value per \$10 note at issuance. The difference, \$1.72 or 17.2%, is a good measure of the hidden costs investors paid at the offering to buy Citigroup's notes.

We compared the TARGETS[®] note to a portfolio initially invested 75% in Intel stock and 25% risk-free Treasury bonds and never rebalanced. Figure 4 illustrates our simulation results.¹³ The expected value of Citigroup's TARGETS[®] at maturity was \$12.85 but the expected value of the Treasury securities and Intel stock portfolio at maturity was \$15.33. For every \$1 in expected value at maturity when the note is superior to the Treasury securities and stock portfolio, investors give up \$117 in expected value at maturity when Citigroup's TARGETS note is inferior to the Treasury securities and Intel stock portfolio.

¹² Other brokerage firms including Merrill Lynch and Morgan Stanley have issued notes tied to Intel stock.

¹³ As with the JP Morgan note, because the value of the Intel-linked TARGETS[®] note is a function of the pattern of interim returns over the note's term and not just the level of the index at maturity, we plot the average value of the note for each index level considering all the possible paths to arrive at that level.

Figure 4
Citigroup Intel-linked TARGETS
and 25% Treasuries / 75% Stock Portfolio



The portfolio of Treasury securities and Intel stock is worth more than the expected value of the TARGETS[®] note for virtually all levels of Intel's stock price on February 15, 2008. Based on realistic assumptions, we determined that investors who bought Citigroup's Intel-linked TARGETS[®] at issuance would be worse off 94% of the time at maturity compared to the buy-it-and-forget-about-it portfolio of stocks and Treasury securities. As with the previous examples, incorporating periodic rebalancing of the Intel stock and bonds portfolio based on simple rules of thumb makes it worth more than Citigroup's Intel-linked TARGETS[®] **100%** of the time.

IV. Additional Considerations

In addition to being complicated and costly as demonstrated above, equity-linked notes are illiquid, have disadvantageous tax treatment and are difficult to properly monitor.

Trading volume in equity-linked notes is miniscule compared to the stocks or stock indexes they are linked to. For example, from the issue date of Citigroup's Intel-linked note, Intel has traded an average of sixty-five million shares per day - more than seven thousand times the average daily trading volume of Citigroup's Intel-linked notes. If we compare the dollar value of trading volume instead of just the number of shares, Intel's average daily volume is closer to twenty thousand times as great as the note's average trading volume.

The IRS imputes interest income to equity-linked notes even if the note does not pay a coupon, meaning investors might need to pay taxes each year out of other resources. The returns on these notes are treated as ordinary income and taxed at current margin income tax rates rather than at the typically lower capital gains rates which would be applied to capital gains on the stock portion of the stock and bonds portfolio.

Sophisticated analysis is required to determine the effective allocation between stocks and bonds in an equity-linked note. Investors who purchase an equity-linked note in any significant amount will therefore not be able to effectively monitor and rebalance his or her portfolio. Moreover, because of the structure of these notes, the effective asset allocation moves perversely with dictates of prudent portfolio rebalancing.¹⁴

V. Regulation

Equity-linked notes are registered with the Securities and Exchange Commission and are sold by brokerage firms. The NASD has issued several Notices to Members addressing its concern that structured products are inappropriately being sold to retail investors. These notices – NTM 03-71 *Non-Conventional Investments*, NTM 05-26 *New Products* and NTM 05-59 *Structured Products* – each make the same basic points.

1. **Members must perform due diligence to understand the material features of the structured product.** Equity-linked notes are financially

¹⁴ See William Reichenstein, "Insured Investment Products: The Reality Behind the Hype", AAIL Journal, November 2004, pp. 10-15.

equivalent to combinations of bonds and options on the linked stock or stock index. It is relatively straightforward for the issuers and brokerage firms selling these products to model and value these components.

... a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards. [*Notice to Members* 05-59, page 5.]

2. **Members must perform a “reasonable basis” suitability**

determination. This first level suitability analysis focuses on the product and determines whether the product is suitable for *any* investor. The modeling required for effective due diligence should allow brokerage firms to determine the value of the equity-linked note at issue and in the secondary market by comparison to the cost of the simpler bond and option components which replicate the payoffs at maturity of the structured product.

...NASD expects members to exercise their market expertise to recognize those situations where the materiality of difference is not in doubt and, consequently, identify that the lower yielding instrument does not represent a reasonable rate of return given the attendant risks as compared to other similarly composed products or direct investments in the underlying components of such products with similar risk/reward attributes. [*Notice to Members* 05-59, page 6.]

3. **Members must perform client-specific suitability determinations.**

Structured products that pass the reasonable-basis suitability analysis must then be evaluated on a client-by-client basis for suitability. The risk return tradeoff embodied in the structured product must be appropriate for the potential investor and the investor must understand the product. Moreover, analogizing structured products to combinations of stocks or bonds and options the NASD reminds members that

Rule 2860(b)(19)(B) requires that “no member or person associated with a member shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has 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 option contract”. [Notice to Members 05-59, page 6.]

4. **Members must present fair and balanced disclosures of the material aspects of the structured product.** The NASD appears to have been especially concerned that promotional materials would be incomplete and therefore false and misleading – violations of the NASD rules which cannot be cured by statements in an accompanying prospectus or prospectus supplement.

Members are further reminded that providing risk disclosure in a prospectus supplement does not cure otherwise deficient disclosure in sales material, even if such sales material is accompanied or preceded by the prospectus supplement. [Notice to Members 05-59, page 3.]

5. **Members must train their registered representatives and have adequate supervisory procedures in place.** Firms must have written procedures to adequately analyze new products and to ensure that registered representatives are adequately trained to - and in fact do - carefully evaluate the suitability of the new product on a customer by customer basis. Written procedures must also be developed to make sure all sales materials provide a fair and balanced portrayal of the risks and rewards on a structured product.

Training for all persons should emphasize that, due to the unique nature of these products, many investors, especially retail investors, may not understand the features of the product, and may not fully appreciate the associated risks of investing in them. Moreover, in light of the fact that investors may be turning to these products as an alternative to traditional equity and fixed income investments, it is crucial for registered persons to have a full and balanced understanding regarding both the risks and the rewards of these products. [Notice to Members 05-59, page 7.]

VI. Conclusion

Equity-linked notes are complex, opaque and expensive – and the more complex and opaque they are, the more expensive they are. Even with the best disclosure materials and the most thoroughly trained and supervised registered representatives, it is unlikely that retail investors can understand the risk-return tradeoff and the costs being incurred in some of the complex equity-linked notes and structured products currently being marketed.

Moreover, we find simple portfolios of stocks and bonds can be purchased and periodically rebalanced which will yield more wealth at maturity than an investment in any of the three equity-linked notes we have analyzed at issuance whatever the level of the S&P 500 or whatever the stock price. These products add nothing to retail investors' portfolios that can't be acquired from investments "already available in the market in the form of less risky, less complicated, or less costly products" and therefore fail the "reasonable-basis" suitability requirement for sale to retail investors.

NASD Notices to Members

Structured Products

Notice to Members

NOVEMBER 2003

INFORMATIONAL

SUGGESTED ROUTING

Legal/Compliance
Retail
Senior Management
Internal Audit

KEY TOPICS

Advertising and Sales Literature
Due Diligence
Non-Conventional Investments
Suitability

Non-Conventional Investments

NASD Reminds Members of Obligations When Selling Non-Conventional Investments

Executive Summary

In the aftermath of the recent downturn in the equity markets, NASD reviewed the services and products offered by members and observed that retail investors were being offered an array of different investments as alternatives to conventional equity and fixed-income investments. These alternative investments do not fall under a common category; the staff review indicates that brokers and retail investors have shown increased interest in products such as asset-backed securities, distressed debt, and derivative products (for ease of reference these products are collectively referred to as non-conventional investments or "NCIs"). NCIs often have complex terms and features that are not easily understood. NASD staff reminds members that the fact that an investment is an NCI does not in any way diminish a member's responsibility to ensure that such a product is offered and sold in a manner consistent with the member's general sales conduct obligations. This *Notice to Members* reminds members offering NCIs of their obligations to: (1) conduct adequate due diligence to understand the features of the product; (2) perform a reasonable-basis suitability analysis; (3) perform customer-specific suitability analysis in connection with any recommended transactions; (4) provide a balanced disclosure of both the risks and rewards associated with the particular product, especially when selling to retail investors; (5) implement appropriate internal controls; and (6) train registered persons regarding the features, risks, and suitability of these products.

Questions/Further Information

Questions regarding this *Notice* may be directed to Gary L. Goldsholle, Associate General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8104; or Janene Marasciullo, Senior Attorney, Regulatory Policy and Oversight, NASD, at (202) 974-2978.

Background and Discussion

As a result of the recent downturn in the equity markets and historically low interest rates, brokers and retail investors have been turning to alternative investment vehicles in search of a better return or yield on investments. A review of members indicated that there is an increased interest in a variety of NCIs that have a wide array of terms, conditions, risks, and rewards.¹ Some of these NCIs are marketed as offering greater security or a “guaranteed” return on investments. Other products seek to maximize the potential return on investments. Some of these products have unique features relating to risk and reward that may not be readily understood, especially by retail investors.

For example, certain asset-backed securities and corporate bonds are secured by a range of collateral such as mobile homes, future royalty payments on popular music, payments from consumer credit cards or other consumer goods. The credit risks associated with these myriad forms of collateral are varied and for many non-institutional parties may be difficult to understand and assess. Other NCIs, such as distressed corporate bonds and certain derivative contracts, may be offered to retail investors in an attempt to maximize the return on investment, but they correspondingly may involve greater degrees of risk. These products also tend to have less market liquidity, less transparency as to their pricing and value and may entail significant credit risks that are difficult to understand and assess.

In sum, recent trends indicate that brokers and investors may be turning to NCIs in search of increased yield or return. Although these products may have attractive qualities, it is crucial that members understand the distinct features, and risks and rewards, of any product they sell. Thus, whenever members recommend NCIs to investors, they must take special care to ensure that all registered persons understand the features of the product in order to be in a position to perform the required suitability analysis before executing a transaction. Likewise, members have an obligation to ensure that all marketing materials used by the member provide an accurate and balanced description of the risks and rewards.

NASD is issuing this *Notice to Members* to remind members of their sales conduct obligations.² Given the complex nature of NCIs and the potential for customer harm or confusion, members are cautioned to ensure that their sales conduct procedures fully and accurately address any of the special circumstances presented by the sale of NCIs. Additionally, NASD is concerned that investors, particularly retail investors, may not fully understand the risks associated with these products. Accordingly, NASD reminds members that the sale of NCIs, like more traditional investments, requires them to:

(1) conduct appropriate due diligence with respect to these products; (2) perform a reasonable-basis suitability analysis; (3) perform customer-specific suitability analysis for recommended transactions; (4) ensure that promotional materials used by the member are fair, accurate, and balanced; (5) implement appropriate internal controls; and (6) provide appropriate training to registered representatives that sell these products. Given the complex and, at times, difficult-to-understand nature of NCIs, members should take particular care to assure that they are fulfilling these obligations.

Due Diligence/ Reasonable-Basis Suitability

As NASD noted most recently in *Notice to Members 03-07* (pertaining to hedge fund sales to customers), performing appropriate due diligence is crucial to a member's obligation to undertake the required reasonable-basis suitability analysis.³ A reasonable-basis suitability determination is necessary to ensure that an investment is suitable for some investors (as opposed to a customer-specific suitability determination, discussed below, which is undertaken on a customer-by-customer basis). Thus, the reasonable-basis suitability analysis can only be undertaken when a member understands the investment products it sells. Accordingly, a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product. Moreover, the fact that a member intends to offer an NCI only to institutional investors does not relieve the member of its responsibility to conduct due diligence and a reasonable-basis suitability analysis.

The type of due diligence investigation that is appropriate will vary from product to product. However, there are some common features that members must understand about products before registered representatives can perform the appropriate suitability analysis. These features include, but are not limited to:

- ◆ The liquidity of the product
- ◆ The existence of a secondary market and the prospective transparency of pricing in any secondary market transactions
- ◆ The creditworthiness of the issuer
- ◆ The creditworthiness and value of any underlying collateral
- ◆ Where applicable, the creditworthiness of the counterparties
- ◆ Principal, return, and/or interest rate risks and the factors that determine those risks
- ◆ The tax consequences of the product
- ◆ The costs and fees associated with purchasing and selling the product

Members should examine these and other appropriate factors when conducting due diligence. A member may in good faith rely on representations concerning an NCI contained in a prospectus or disclosure document. However, reliance on such materials alone may not be sufficient for a member to satisfy its due diligence requirements where the content of the prospectus or disclosure document does not provide the member with sufficient information to fully evaluate the risk of the product or to educate and train its registered persons for sales purposes. In such case, the member must seek additional information about the NCI or conclude that the product is not appropriate for sale to the public. In addition, members should ensure that the persons responsible for conducting due diligence have appropriate training and skill to evaluate the terms of the investment as well as the potential risks and benefits.

Customer-Specific Suitability

Members and their associated persons must reasonably believe that the product is a suitable investment prior to making a recommendation to a particular customer. To ensure that a particular investment is suitable for a specific customer, members and their registered persons must examine: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.⁴

NASD cautions members against relying too heavily upon a customer's financial status as the basis for recommending NCIs. A customer's net worth alone is not necessarily determinative of whether a particular product is suitable for that investor. Given the unique nature of NCIs, these products may present challenges when it comes to a member's duty to dispense its suitability obligation; however, the difficulty in meeting such challenges cannot be considered as a mitigating factor in determining whether members have met their suitability obligations. NCIs with particular risks may be suitable for recommendation to only a very narrow band of investors capable of evaluating and being financially able to bear those risks.

Promotional Materials

Sales materials and oral presentations regarding NCIs must present a fair and balanced picture regarding both the risks and benefits of investing in these products. For example, members may not claim that certain NCI products, such as asset-backed securities, distressed debt, derivative contracts, or other products, offer protection against declining markets or protection of invested capital unless these statements are fair and accurate. Moreover, when promoting the advantages of NCIs, it is critical that members balance their promotional materials with disclosures of the corresponding risks and limitations of the product discussed above in the "Due Diligence/Reasonable Basis Suitability" section of this *Notice*.

Additionally, if applicable, members should provide investors with any prospectus and other disclosure material provided by the issuer or the sponsor. NASD reminds members, however, that simply providing a prospectus or offering memoranda does not cure unfair or unbalanced sales or promotional materials, whether prepared by the member, sponsor, or issuer.⁵

Internal Controls

Members must establish sufficient internal controls, including supervision and training requirements, that are reasonably designed to ensure that sales of NCI's comply with all applicable NASD and SEC rules. Members must ensure that their written procedures for supervisory and compliance personnel require that (1) the appropriate due diligence/reasonable-basis suitability is completed before products are offered for sale; (2) associated persons perform appropriate customer-specific suitability analysis; (3) all promotional materials are accurate and balanced; and (4) all NASD and SEC rules are followed. In addition to establishing written procedures, members also must document the steps they have taken to ensure adherence to these procedures.

Training

Members must train registered persons about the characteristics, risks, and rewards of each product before they allow registered persons to sell that product to investors. Likewise, members should train registered persons about the factors that would make such products either suitable or unsuitable for certain investors. Members' focus on training should not be limited to representatives selling such products; members also should provide appropriate training to supervisors of registered persons selling NCI's.

For a variety of reasons, the need for adequate training is heightened when registered persons sell NCI's. First, due to the unique nature of these products, many investors, especially retail investors, may not understand the features of the product, and may not fully appreciate the associated risks of investing in them. Moreover, in light of the fact that investors may be turning to these products as an alternative to traditional equity and fixed income investments, it is crucial for registered persons to provide a full and balanced disclosure regarding both the risks and the rewards of these products.

Educational brochures, videos, lectures, explanatory memoranda, and Web-based seminars are all appropriate ways of delivering training. The particular training methods will vary based upon the products themselves, as well as the size and customer base of the firm. NASD encourages firms that offer NCI's to offer training about these products as part of the Firm Element of their Continuing Education Program.

Conclusion

NClS can be unusual and complex investment vehicles that may appear increasingly attractive to investors during periods in which traditional equity and fixed income investments come into disfavor. However, the unique and complex features of some NClS may be difficult to understand and may obscure the risks. Accordingly, members must conduct appropriate due diligence/reasonable-basis suitability before offering any product to the public. Likewise, members must conduct a customer-specific suitability analysis prior to making any recommendations to a customer. Members also must ensure that all promotional materials are fair, accurate, and balanced. Finally, in connection with the recommendation and sale of NClS, members must ensure that they implement appropriate supervisory internal control and appropriate training to all registered persons who sell such products to customers.

Endnotes

- 1 Approximately 35% of the firms reviewed sold NClS in denominations that raise the possibility of sales to retail investors. The list of NClS being offered is broad and includes asset-backed securities, index-linked notes, non-traded REITS, equity-linked notes, multi-callable step up notes, redeemable secured notes, auction rate preferred securities, principal protected index-linked CDs, distressed debt, derivative products, and emerging market debt securities.
- 2 Members also are reminded of the application of IM-2310-2(e) (Fair Dealing with Customers with Regard to Derivative Products or New Financial Products), which emphasizes members' obligations for fair dealing with customers when making recommendations or accepting orders for new financial products.
- 3 NASD's use of the term "due diligence" is not intended to equate the responsibilities of a member for its sales conduct obligations with the requirements of an underwriter under Section 11 of the Securities Act of 1933 and Securities Act Rule 176.
- 4 NASD Conduct Rule 2310(b).
- 5 See NASD Letter of Acceptance, Waiver and Consent, Altegris Invs., Inc., and Robert Amedeo, No. CAF030015 (April 15, 2003).

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Notice to Members

APRIL 2005

SUGGESTED ROUTING

Internal Audit
Legal and Compliance
Retail
Senior Management

KEY TOPICS

Best Practices
New Products
Non-Conventional Instruments
Rule 3010
Suitability

GUIDANCE

New Products

NASD Recommends Best Practices for Reviewing New Products

Executive Summary

NASD is concerned about the number of increasingly complex products that are being introduced to the market in response to the demand for higher returns or yield. Some of these products have unique features that may not be well understood by investors or registered persons. Others raise concerns about suitability and potential conflicts of interest. While NASD has and will continue to address specific products as appropriate, NASD also urges firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products. At a minimum, those procedures should include clear, specific and practical guidelines for determining what constitutes a new product, ensure that the right questions are asked and answered before a new product is offered for sale, and, when appropriate, provide for post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution.

The purpose of this *Notice* is to remind firms of the kind of questions they should be asking before offering a new product, and to highlight a number of best practices employed by some firms that NASD believes others should consider in reviewing their current procedures.

Questions/Further Information

Questions concerning these new reporting provisions can be directed to Eric Moss, Vice President and Director of Emerging Regulatory Issues, at (202) 728-8982; or Laura Gansler, Associate General Counsel, at (202) 728-8275.

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Background and Discussion

In the current investment environment, investors and brokers are increasingly turning to alternatives to conventional equity and fixed-income investments in search of higher returns or yields. Such products, including asset-backed securities, distressed debt, structured notes, and derivative products, are often complex or have unique features that may not be fully understood by the retail customers to whom they are frequently offered, or even by the brokers who recommend them. Some appear to offer benefits to investors that are already available in the market in the form of less risky, less complicated, or less costly products, prompting concerns about suitability and potential conflicts of interest.

In 2003, NASD published *Notices to Members (NTMs)* addressing the sale of hedge funds and non-conventional instruments to retail customers.¹ More recently, we have proposed new rules tailored specifically to sales of deferred variable annuities, including new sales practice standards, supervisory approval and sales force training requirements,² and a new rule establishing pre-use advertising filing requirements for certain products not previously offered by the selling firm.³ And, as discussed more fully below, we met with numerous firms during the past year to learn more about their practices for developing and vetting new products.

NASD continues to monitor new products carefully and will respond to specific products and problem areas as appropriate. However, we also urge firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products from a regulatory perspective. While suitability requirements and other sales practice obligations attach to the recommendation and sale of a product, adequate procedures for reviewing new products before they are offered to the public can greatly enhance a firm's ability to detect and avoid conflicts, unsuitable recommendations, and other problems before violations occur.

Written Procedures for Vetting New Products

As part of the supervisory responsibilities imposed by NASD Rule 3010, all firms that sell new products should have formal written procedures to ensure that no new product is introduced to the marketplace before it has been thoroughly vetted from a regulatory as well as a business perspective. At a minimum, those procedures should identify what constitutes a new product, and ensure that the right questions are asked and answered before a new product is offered for sale.

What Is a New Product?

As a threshold matter, a firm's written procedures should include clear, specific, and practical guidelines for determining what constitutes a new product, including when a modification of an existing product is material enough to warrant the same level of review as a new product. Among the things to consider are:

- ◆ Is the product new to the marketplace or the firm?
- ◆ Is the firm proposing to sell a product to retail investors that it has previously only sold to institutional investors? Will the product be offered by representatives who have not previously sold the product?
- ◆ Does the product involve material modifications to an existing product, whether risk to the customer, product structure, or fees and costs?
- ◆ Does the product require material operational or system changes?
- ◆ Is the product an existing product that is being offered in a new geographic region, in a new currency, or to a new type of customer?
- ◆ Would the product involve a new or significant change in sales practices?
- ◆ Does the product raise conflicts that have not previously been identified and addressed?

This list is not necessarily exhaustive of all factors that determine whether a product is new. Firms should not simply assume that if something is "like" a product already in the marketplace, whether offered by the firm or by competitors, that little or no review is necessary. NASD believes that when firms are unsure as to whether something warrants new product review, the best practice is to err on the side of caution, and subject any material modification to an existing product (whether the existing product is sold by the firm or not) to the same level of review as a new product. It is also important that the standards for determining what level of review is appropriate for any given product or modification of a product are clearly communicated and applied throughout the firm in a consistent manner.

Ask the Right Questions

The fundamental goal of every vetting process should be to ensure that the right questions are asked during the review period. Consequently, a firm's policies and procedures addressing new products should be designed to answer these questions. While the right questions will depend in part on the nature of the product, NASD believes that, at a minimum, every firm should ask and answer the following questions before a new product is offered for sale:

- ▶ 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? How does the product add to or improve the firm's current offerings? Can less costly, complex, or risky products achieve the objectives of the product?
- ▶ What assumptions underlie the product, and how sound are they? What market or performance factors determine the investor's return?
- ▶ What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks to principal?
- ▶ What costs and fees for the investor are associated with this product? Why are they appropriate? Are all of the costs and fees transparent? How do they compare with comparable products offered by the firm or by competitors?
- ▶ 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? For example, does the firm stand to benefit from the sale of the product beyond the clearly disclosed sales charges or commissions (*i.e.*, revenue sharing arrangements)? If so, the firm may have an obligation under NASD Rule 2110, governing just and equitable principles of trade, to disclose that conflict, even if the product is otherwise suitable, generally or for a particular investor.
- ▶ Does the product present any novel legal, tax, market investment, or credit risks?
- ▶ What is the complexity of the product in structure, function, and description? Does such complexity impair understanding and transparency of the product? Does such complexity impact suitability considerations and/or the training requirements associated with the product?
- ▶ How will the product be marketed? What promotional and sales materials will be used? What risks must be disclosed, and how will that disclosure be made? Some firms require that sales materials be included in the package provided to the committee that will make the final decision.

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- ▶ What are the qualifications of the people making determinations about a new product's assumptions, performance, and risk, and do such qualifications comport with the expertise necessary to reach sound conclusions?
 - ▶ Will the product necessitate the development or refinement of in-firm training programs for registered representatives and their supervisors? If so, how and when will the training be provided?
 - ▶ Will this product be sold only by the firm, or by third parties? How liquid is the product? Is there a secondary market for the product?
 - ▶ Do the firm's current systems support the product, or will new systems be required? If promises will be made to customers (such as volume-based discounts), can current systems deliver on those promises?
 - ▶ Does the structure or a feature of the new product, including the proposed sales plan, implicate any additional regulations (*i.e.*, NASD Rule 2860 or NASD Rule 2720)?

Asking the right questions is critical not only to determine if the product should be offered at all (is it suitable for targeted investors, does it present insurmountable conflicts between the firm and its customers), but also to identify important features of the product that should be highlighted for the sales and marketing staff, and to plan for appropriate training and supervision.

Survey of Best Practices

To help firms determine whether their current procedures for vetting new products are appropriate, NASD has surveyed a number of firms that manufacture proprietary products and/or distribute third-party products and has conferred with certain of its committees, including the NASD Consultative Committees. The remainder of this *Notice* highlights practices employed by some firms that NASD believes others should consider. These practices can make it easier for firms to comply with their various suitability obligations, avoid conflicts, and plan for appropriate training and supervision. This *Notice* is not intended to be a comprehensive roadmap for compliance and supervision with respect to vetting new products, but rather highlights measures that some firms are using to ensure better compliance. Firms should consider the information in this section of the *Notice* in assessing their own procedures and in implementing improvements that are tailored to and work best for their firm. We note that while a particular sound practice may work well for a large firm, the same approach may not be effective or economically feasible for a smaller firm. While firms must adopt procedures and controls that are effective given their size, structure, and operations, a firm may not fail to have policies and procedures concerning new products reasonably designed to achieve compliance with NASD rules and the federal securities laws because of the limitation of its size, structure, or operations. Using the information in this *Notice* may be helpful, but it is not designed as a safe harbor as circumstances may dictate different practices, processes, and procedures.

While the procedures used by the firms we surveyed vary slightly depending on their own business model and culture, they tended to share the following components:

- ▶ A mandatory, standardized process that requires a written “new product” proposal and thorough accompanying documentation, that:
 - assigns clear “ownership” of the product or concept to a particular business unit, product group, or department;
 - is clearly communicated to, and has a high profile within, the firm; and
 - is easily accessible to the business units, often through internal Web-based applications that encourage standardization and uniformity;
- ▶ A preliminary assessment of a proposed product or concept by compliance and/or legal personnel to determine, among other things, whether it is a new product or a material modification of an existing product, and the appropriate level of internal review;
- ▶ For new products or material modifications to existing products, detailed review by a committee or working group made up of representatives from all relevant sectors of the firm, including compliance, legal, finance, marketing, sales, and operations;
- ▶ A formal decision to approve, disapprove, or table the proposal by a new product committee or other decision-making group that includes members of the firm’s senior management; and
- ▶ If the product is approved, some level of post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution.

Initial Product Review

Whatever the specifics of a firm’s review process, the most successful processes require review and sign-off by every relevant department, before the product is presented to the new products committee for formal approval.

A number of firms stressed the importance of involving legal and compliance personnel at the earliest possible stage. Some firms do this by having compliance and legal personnel attached to specific business units or product groups, so that ideas can be informally discussed with them as the ideas arise. Others include compliance and legal personnel in the initial product assessment, as well as in the detailed review. However it is done, firms that include these perspectives early in the development process report that their business units are likely to view compliance personnel as a positive “part of the team,” rather than as a stumbling block. The opposite can also be true. When compliance is involved only at the end of the process, there may be less time or inclination to modify the product to address compliance concerns, and the sponsors of the product may have a more adversarial relationship with the compliance and legal teams.⁴

The firms we surveyed also reported that it is extremely helpful to have operations, sales, and supervisory personnel participate in the product review process, rather than waiting until after a product has been approved to determine what training, controls, or operational enhancements are necessary. Many important questions are best answered by those personnel. For example, they may be in the best position to determine whether current systems support the product, including delivering on promises such as volume-based discounts. If additional training is required, firms should plan in advance how that training will be administered, and how the firm will ensure that only brokers who have had the required training are allowed to offer the product to customers. Firms also should plan to ensure that the necessary training is available as long as the product is offered. Consideration also should be given to whether offering the product will require any additional licensing for sales personnel.

Firms manage the initial review process differently, with many utilizing Web-based applications to streamline and document the process. While some firms rely on the proposing business unit to shepherd a product through the process, at least one firm has established an independent new products group that is responsible for managing the process and ensuring that all relevant departments have reviewed and signed off on the proposed product before it is submitted for formal approval. The new products group also formally notifies all relevant departments about product modifications that it deems do not warrant full review in a process of negative consent; if any department disagrees with the new product group's initial assessment, the product is submitted for full review.

Formal Approval

After the appropriate initial review has been completed, most of the firms we surveyed require formal approval by a committee consisting of representatives from senior management before a product can be offered, which enhances a firm's ability to apply consistent standards and ensures accountability. The committee may base its decision on a written proposal supported by detailed documentation, an oral presentation, or, as in most cases, both. A number of firms reported that approval of complex or unusual products will often be made contingent of specific limitations or conditions, including to whom the product can be sold, what kind of training must be required, or what kind of market conditions must exist for the approval to remain effective. For example, the product may be approved on the condition that it is offered only to customers whose investment objectives are coded "speculative," who have a certain minimum risk tolerance level, or who have a minimum net wealth. (While these limitations may be helpful, NASD cautions that there is no substitute for a suitability analysis, and "accredited" status under Regulation D of the Securities Act of 1933 is not necessarily an indicator of sophistication, particularly if the value of the investor's home constitutes a significant percentage of his or her net wealth.) Other conditions of approval might include that no more than a set percentage of a customer's net worth be invested in the same or a similar product. In such cases, it is important to determine prior to approval whether that any conditions or limitations are feasible from a training, supervisory, and operations point of view.

Post-Approval Review

Some firms require that complex products, those approved on a contingent or limited basis, or those based on critical market assumptions, be formally reviewed for a specific period of time, often six months or a year. This allows the firm to assess product performance, determine whether product limitations and other post-sale compliance requirements are met, and to evaluate whether market conditions have altered the risks associated with the product. Firms also should ensure that they:

- ◆ track and monitor customer complaints and grievances relating to new products;
- ◆ reassess the firm's training needs regarding a product on a continuing basis;
- ◆ establish procedures to monitor, on an ongoing basis, firm-wide compliance with any terms or conditions that have been placed on the sale of the product;
- ◆ periodically reassess the suitability of the product; and
- ◆ review any product before lifting any restrictions or conditions on the sale of the product.

Conclusion

NASD urges firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products from a regulatory perspective. At a minimum, firms should have in place written procedures for determining what is a new product, and for making sure that the right questions are asked and answered before a new product is offered for sale. In addition, while NASD recognizes that what specific procedures are appropriate will vary depending on firm size and structure, we believe that the best practices identified above can help firms avoid conflicts, unsuitable recommendations, and other problems before violations occur. Finally, NASD notes that even the most elaborate procedures will not be effective unless they are rigorously implemented, something that ultimately depends on the firm's culture and the level of commitment on the part of the firm's leadership.

Endnotes

- 1 NASD Reminds Members of Obligations When Selling Hedge Funds, *NTM 03-07* (February 2003), and Non-Conventional Investments, *NTM 03-71* (November 2003).
- 2 Proposed New Rule 2821 Regarding Transactions in Deferred Variable Annuities, SR-NASD-2004-183 (December 2004).
- 3 See *NTM 05-25* (April 2005) (NASD Requests Comment on Proposal to Require Pre-Use Filing of Advertisements and Sales Literature for New Types of Securities and of Television, Video and Radio Advertisements; Comment Period Expires May 20, 2005).
- 4 Nothing in this *Notice* is intended to imply that consultation with legal and compliance personnel in itself alters or shifts supervisory responsibilities within the firm.

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Notice to Members

SEPTEMBER 2005

SUGGESTED ROUTING

Internal Audit
Legal and Compliance
Retail
Senior Management

KEY TOPICS

Derivatives
Options
Structured Products
Structured Securities

GUIDANCE

Structured Products

NASD Provides Guidance Concerning the Sale of Structured Products

Executive Summary

As a result of a recent review of members that sell structured products, NASD staff is concerned that members may not be fulfilling their sales practice obligations when selling these instruments, especially to retail customers. This *Notice to Members* 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.

Questions/Further Information

Questions regarding this *Notice* may be directed to Gary L. Goldsholle, Associate Vice President and Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8104.

Background

Structured products are securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency.¹ As the foregoing definition suggests, there are myriad types of structured products. Some structured products offer full protection of the principal invested, whereas others offer limited or no protection of the principal.

Most structured products pay an interest or coupon rate substantially above the prevailing market rate.² Structured products also frequently cap or limit the upside participation in the reference asset, particularly if some principal protection is offered or if the security pays an above-market rate of interest.

Structured products, which are typically issued by investment banks or their affiliates, have a fixed maturity. Some, but not all, structured products may be listed on a national securities exchange. Moreover, even those structured products listed on a national securities exchange may be very thinly traded.

Structured products typically have two components—a note and a derivative (often an option). The note pays interest to the investor at a specified rate and interval. The derivative component establishes the payment at maturity. In some products, the derivative is, in effect, a put option sold by the investor that gives the issuer the right, but not the obligation, to sell the investor the reference security or securities at a predetermined price. In other products, the derivative is, in effect, a call option sold by the investor that gives the issuer the right, but not the obligation, to buy from the investor the reference security or securities at a predetermined price. Despite the derivative component of a structured product, they are often marketed to investors as debt securities.

Sales of structured products began in the 1980s. The products gained popularity with institutional investors in the 1990s. More recently, members have reported to NASD that structured products have been increasingly targeted at retail investors. Many of the structured products targeted at retail investors are based upon “blue-chip” and “household-name” stocks that comprise the S&P 500 or the NASDAQ-100 indexes. NASD staff has concerns about the manner in which structured products may be marketed to retail investors and the types of investors purchasing such products. As such, NASD is issuing this guidance to members addressing sales practice issues.

Regulatory Requirements

The application of NASD rules to activities involving structured products, including Rules 2110 (Standards of Commercial Honor and Principles of Trade), 2210 (Communications with the Public), 2310 (Recommendations to Customers), 2720 (Distribution of Securities of Members and Affiliates—Conflicts of Interest), 3010 (Supervision), and 3012 (Supervisory Control Systems), is discussed below.

1. Promotion of Structured Products

Offerings of structured products generally are conducted as public offerings of securities registered under the Securities Act of 1933. In most cases, structured products are offered from a shelf registration. An investor purchasing a structured product as part of a shelf distribution will, prior to purchase, receive a preliminary prospectus supplement that describes the characteristics and risks of the structured product being offered. To varying degrees, members also use supplemental sales materials. NASD staff has observed that the disclosures provided in supplemental sales materials tend to be less balanced and offer fewer risk disclosures than are contained in the preliminary and final prospectus supplements.

NASD reminds members that pursuant to Rule 2210, all sales materials and oral presentations regarding structured products must present a fair and balanced picture regarding both the risks and benefits. For example, marketing materials should not portray structured products as “conservative” or a source of “predictable current income” unless such statements are accurate, fair, and balanced. In addition, Rule 2210 prohibits exaggerated statements and the omission of any material fact or qualification that would cause a communication to be misleading. Moreover, in promoting the advantages of structured products, such as the interest rate offered and the creditworthiness of the issuer, it is necessary that members balance their promotional materials with disclosures concerning the attendant risks, which may include loss of principal and the possibility that at expiration the investor will own the reference asset at a depressed price. In general, NASD staff believes that sales materials and oral presentations that omit a description of the derivative component of the product and instead present such products as ordinary debt securities would violate Rule 2210. In addition, members should be careful to balance any statements concerning the fact that a structured product has a ticker symbol or has been approved for listing on an exchange with the risks that an active and liquid trading market may not develop. Members are further reminded that providing risk disclosure in a prospectus supplement does not cure otherwise deficient disclosure in sales material, even if such sales material is accompanied or preceded by the prospectus supplement.³

In some cases, structured products are assigned a credit rating by a nationally recognized statistical rating organization. To the extent that such credit rating pertains to the creditworthiness of the issuer (*i.e.*, the ability of the issuer to meet its obligations under the terms of the structured product) and is not indicative of the market risk associated with the structured product or the reference security, members must be careful to delineate these distinctions. Presentation of a credit rating for a structured product that suggests that the rating pertains to the safety of the principal invested or the likely investment returns will be viewed as misleading. Members presenting a credit rating must address the fact that the creditworthiness of the issuer does not affect or enhance the likely performance of the investment other than the ability of the issuer to meet its obligations.

2. Eligible Accounts

A. Approved Accounts

Member firms also should consider whether purchases of some or all structured products should be limited to investors that have accounts that have been approved for options trading. Given the similar risk profile of many structured products and options, particularly those where principal invested is at risk from market movements in the reference security, it may be an appropriate investor safeguard to require that such structured products only be purchased in accounts approved for options trading. Firms that determine not to limit purchases of structured products in which investors' principal is at risk from market movements in the reference security to accounts approved for options trading should develop other comparable procedures designed to ensure that structured products are only sold to persons for whom the risk of such products is appropriate. These firms should be prepared to demonstrate the basis for allowing investors with accounts not approved for trading options to purchase structured products.

Members also are reminded that approving an account to trade structured products is not a substitute for a thorough suitability analysis. Not every structured product will be suitable for every account approved to trade structured products. A discussion of suitability is provided below.

B. Discretionary Accounts

Sales of structured products issued by a member, or an affiliate of a member, to discretionary accounts must comply with Rule 2720 (Distribution of Securities of Members and Affiliates—Conflicts of Interest). Specifically, paragraph (l) (Discretionary Accounts) provides that "a transaction in securities issued by a member or an affiliate of a member, or by a company with which a member has a conflict of interest shall not be executed by any member in a discretionary account without prior specific written approval of the customer." Members should review their written supervisory procedures and practices to ensure that they request and obtain the necessary written approval of the customer before purchasing structured products in a discretionary account.

3. Suitability and Fair Dealing with Customers

A. Fair Dealing with Customers with Regard to Derivative Products or New Financial Products

IM-2310-2(e) (Fair Dealing with Customers with Regard to Derivative Products or New Financial Products) emphasizes members' obligations to deal fairly with customers when making recommendations or accepting orders for new financial products. The IM states that "[a]s new products are introduced from time to time, it is important that members make every effort to familiarize themselves with each customer's financial situation, trading experience, and ability to meet the risks involved with such products and to make every effort to make customers aware of the pertinent information regarding the products."

For certain enumerated products, including a type of structured product listed on NASDAQ known as "Selected Equity-Linked Debt Securities" (SEEDS), IM-2310-2(e) provides specific guidelines that members must follow for "qualifying accounts to trade the products and for supervising the accounts." In this regard, Rule 4420(g)(5) requires prior to the commencement of trading of particular SEEDS, delivery to a broker-dealer of a circular providing guidance regarding its compliance responsibilities (including suitability recommendations and account approval) when handling transactions in SEEDS.⁴ Similar disclosure requirements exist with respect to the listing standards of structured products on national securities exchanges.⁵

B. Reasonable Basis Suitability

As noted in *Notices to Members (NTMs) 03-07* and *03-71*, a member has an obligation to perform a reasonable basis suitability determination before recommending a product to investors. A reasonable basis suitability determination is necessary to ensure that a security—in this case a structured product—is suitable for some investors (as opposed to the customer-specific suitability determination, which is made on an investor-by-investor basis). To discharge its reasonable basis suitability obligation, a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards. Members also are reminded of the guidance issued in *NTM 05-26*, which provides best practices for developing and vetting new products, including structured products.

Members should consider whether an investment in a structured product meets the reasonable basis suitability standard if the instrument is priced such that the potential yield is not an appropriate rate of return in relation to the volatility of the reference asset based upon comparable or similar investments, in terms of structure, volatility, and risk in the market as determined at the time the structured product is issued. For example, similar structured products based on reference securities that possess substantially similar volatility characteristics, but which offer materially different rates of return in the note component, should call into question whether the instrument with the lower yield meets the reasonable basis suitability standard. While an exact risk/reward calibration among different instruments or investments may not be

possible, NASD expects members to exercise their market expertise to recognize those situations where the materiality of difference is not in doubt and, consequently, identify that the lower yielding instrument does not represent a reasonable rate of return given the attendant risks as compared to other similarly composed products or direct investments in the underlying components of such products with similar risk/reward attributes.

C. Customer Specific Suitability

A member also must determine that its recommendation to purchase a structured product is suitable for that particular investor. Under Rule 2310, members must ensure that a recommendation is suitable for a specific customer by examining (1) the customer's financial status, (2) the customer's tax status, (3) the customer's investment objectives, and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

The derivative component of structured products and the potential loss of the principal for many such products may make them unsuitable for investors seeking alternatives to debt securities. While structured products pay interest like debt securities, they often exhibit very different profit and loss potential. The profit and loss potential of many structured products is more akin to an option contract, particularly those where principal invested is at risk from market movements in the reference security. For such products, it may be useful for registered representatives to consider whether the customer meets the suitability requirements for options trading.⁷ In particular, Rule 2860(b)(19)(B) requires that "no member or person associated with a member shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has 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 option contract" (emphases added).

Members also should not make any generalized conclusions about the "relative" suitability of a structured product and an investment in the reference asset. NASD does not believe that members should assume that if an investment in the reference asset is suitable, then an investment in a structured product pertaining to such reference asset also must be suitable. Conversely, members should not assume that if an investment in the structured product is suitable, then so too is an investment in the reference asset. As discussed above, structured products may have very different risk-reward profiles than their reference assets. Suitability must be determined on an investor-by-investor basis, with reference to the specific facts and circumstances of each investor.

Moreover, where an instrument is structured such that there is a risk of losing all or a substantial portion of the principal in return for above-market rate current income, the volatility of the reference asset upon which total return of the investment depends will be an important factor in determining whether it is suitable for a customer. For example, structured product ABC with a highly volatile reference asset may pay an interest rate of 40 percent to account for the risk, whereas structured product XYZ with a less volatile reference asset may only pay an interest rate of 20 percent. Despite the higher interest rate of structured product ABC, the risk of principal owing to the increased volatility of the reference asset may make structured product ABC less suitable for an investor than structured product XYZ notwithstanding its lower interest rate.

4. Supervision and Supervisory Control System

Under Rule 3010, members must establish written supervisory procedures that are reasonably designed to ensure that sales of structured products comply with all applicable securities laws, and SEC and NASD rules. Members must ensure that their written procedures for supervisory and compliance personnel include that (1) reasonable-basis suitability is completed before products are offered for sale; (2) associated persons perform appropriate customer-specific suitability analysis; (3) the firm has procedures to determine accounts eligible to purchase structured products; and (4) all promotional materials are accurate and balanced. In addition, members are reminded that their written supervisory control system required under Rule 3012 requires members to test and verify that their written supervisory procedures are reasonably designed to ensure adequate compliance with all applicable securities laws, and SEC and NASD rules.

Firms also should consider the best practices for vetting new products discussed in *NTM 05-26*. These best practices include having compliance and legal personnel involved in the initial product assessment and having supervisory personnel participate in the product review process.

5. Training

Members must train registered personnel about the characteristics, risks, and rewards of each structured product before they allow registered persons to sell that product to investors. In connection with such training, members should train registered persons about the factors that would make such products either suitable or unsuitable for certain investors. Members' focus on training should not be limited to representatives selling structured products; members also should provide appropriate training to supervisors of registered persons selling structured products.

Training for all persons should emphasize that, due to the unique nature of these products, many investors, especially retail investors, may not understand the features of the product, and may not fully appreciate the associated risks of investing in them. Moreover, in light of the fact that investors may be turning to these products as an alternative to traditional equity and fixed income investments, it is crucial for registered persons to have a full and balanced understanding regarding both the risks and the rewards of these products.

Endnotes

- 1 There is no standardized definition of a structured product in the federal securities laws. SEC Rule 434 (Prospectus Delivery Requirements in Firm Commitment Underwritten Offerings of Securities for Cash) defines structured securities as “securities whose cash flow characteristics depend upon one or more indices or that have embedded forwards or options or securities where an investor’s investment return and the issuer’s payment obligations are contingent on, or highly sensitive to, changes in the value of underlying assets, indices, interest rates or cash flows.” The Pacific Exchange defines structured products as “products that are derived from and/or based on a single security or securities, a basket of stocks, an index, a commodity, debt issuance and/or a foreign currency, among other things” and would include “index and equity linked notes, term notes and units generally consisting of a contract to purchase equity and/or debt securities at a specified time.” Securities Exchange Act Rel. No. 51094 (Jan. 28, 2005), 70 FR 6489 (Feb. 7, 2005) (Order Approving Proposed Rule Change and Amendment No. 1 and 2 Thereto by the Pacific Exchange, Inc. and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 Thereto Relating to a Proposed Listing Fee Schedule for Structured Products). The NYSE defines a structured product as “a security, which is based on the value of another security.” Securities Exchange Act Rel. No. 42746 (May 2, 2000), 65 FR 30171 n.7 (May 10, 2000) (Order Granting Approval to Proposed Rule Change and Amendment No. 1 Thereto Relating to the NYSE’s Allocation Policy and Procedures).
 - 2 NASD staff has observed structured products paying interest rates as high as 40 percent per year.
 - 3 See, e.g., *Department of Enforcement v. Hornblower & Weeks*, 2004 NASD Discip. LEXIS 27 (respondent could not cure defects in disclosure by providing more detail and further disclosure in the same package or by answering questions); *DOE v. Ryan Mark Reynolds*, 2001 NASD Discip LEXIS 17 (“The SEC has held that, in the enforcement context, a registered representative may be found in violation of the NASD’s rules and the federal securities laws for failure to fully disclose risks to customers even though such risks may have been discussed in a prospectus delivered to customers.”); *Department of Enforcement v. Pacific On-Line Trading & Securities*, 2002 NASD Discip. LEXIS 19 (finding that the subsequent dissemination of disclosure information does not cure earlier misleading disclosures).
- Members also should consider whether their disclosures concerning structured products provide a basis for liability under sections 12(a)(2) and 17(a) of the Securities Act of 1933 (Securities Act) or section 10(b)(5) of the Securities Exchange Act of 1934 (Exchange Act). See *In the Matter of Robert A. Foster*, 51 SEC 1211 (1994) (notwithstanding distribution of the prospectuses, party is liable under Section 10(b)(5) of the Exchange Act and Section 17(a) of the Securities Act for making untrue statements of material facts and omitting to state material facts necessary in order to make the statements made not misleading).

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- 4 A nearly identical requirement also exists with respect to listings of “Other Securities” pursuant to Rule 4420(f). See Rule 4420(f)(3).
 - 5 See, e.g., AMEX Rule 107A, PHLX Rule 803(f), NSX Section 1.3, CHX Rule 13.
 - 6 For structured products that are listed on an exchange (or traded on NASDAQ), the applicable listing standards typically require the exchange (or NASDAQ) to issue an information circular regarding compliance responsibilities, including suitability and account approval). See *supra* note 5. Member firms should review these information circulars to ensure that they adhere to the appropriate standards.

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