

**Staff Summary Report on Issues Identified in Examinations of Certain Structured
Securities Products Sold to Retail Investors**

By the staff of the Office of Compliance Inspections and Examinations

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SUMMARY

Broker-dealers have long offered a range of structured securities to institutions and wealthy individuals. Certain structured securities products have been increasingly marketed to retail investors in recent years (referred to here as “SSPs” or “retail SSPs”).¹ Total U.S. sales of SSPs (to both retail and institutional investors) had risen from approximately \$32 billion in 2004 to in excess of \$100 billion in 2007. The demise of Lehman Brothers Holding Co. and its associated default on many SSPs it had issued and distributed, as well as its default on other of its structured products had a sobering effect across the SSP market in 2008. Nonetheless, SSPs seem to have resumed an overall upward sales trend in 2009 and 2010, and SSP sales to retail investors have, on an estimated basis, risen from \$34 billion in 2009 to \$45 billion in 2010.²

Starting in 2007, but predominantly in 2008 and 2009, Inspection staff from the Commission’s Office of Compliance Inspections and Examinations (“OCIE”) reviewed the retail SSPs business of eleven broker-dealers: three large firms affiliated with bank holding companies that issue SSPs through such firms (which may be referred to here as “originating firms”); one wholesaler selling SSPs of an unrelated third party issuer through other broker-dealers; and seven smaller retail firms that also distribute such third-party SSPs. *This report, which discusses the staff’s observations during these examinations, reflects the views of the staff and does not represent findings or conclusions of the Commission. This document should not be considered legal advice.* The staff is considering what additional steps may be appropriate relating to SSPs.

Examination observations of note include evidence of broker-dealers recommending unsuitable SSPs to retail investors and engaging in secondary market purchases from and sales to retail investors at disadvantageous prices. Various examinations of the broker-dealers affiliated with the issuer, as well as the other retail broker-dealers, have identified deficiencies in the firms’ supervisory and compliance structures as they relate to retail SSPs, including a tendency not to recognize SSPs as a distinct product class with special supervisory challenges – including surveillance for sales practice abuses as well as the need for specialized training for sales and supervisory personnel.

The following OCIE staff worked on the examinations underlying this report:

New York Regional Office: *John M. Nee, Rosanne R. Smith, Linda Lettieri, Sonam Varghese,*

¹ See “*An Arcane Investment Hits Main Street*,” Wall Street Journal (June 21, 2006), “*Twice Shy on Structured Products*,” Wall Street Journal (May 28, 2009) and “*Policy Issues Raised By Structured Products*,” Jennifer Bethel & Allen Ferrell, Discussion Paper No. 56010/2006 John M. Olin Center For Law, Economics And Business (Harvard). Broker-dealer examinations conducted by staff from the United States Securities and Exchange Commission and from the Financial Industry Regulatory Authority (“FINRA”) have served to confirm this trend.

² Financial services consulting firm Greenwich Associates indicated, according to Risk.net, that the global retail structured products market made a strong comeback at the end of 2009, and is poised to return to previous levels or may even grow in the near future. An article in *Derivatives Week* (February 3, 2010) contained similar findings. “*Structured Notes: Not as Safe as They Seem*,” Wall Street Journal (November 13, 2010).

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I. Background

Structured products encompass a range of financial instruments, such as securities that derive their value from, and provide exposure to, various asset classes, including, among other things, a single security, baskets of securities, indices, options, commodities, debt issuances and/or foreign currencies.³ SSPs are a subset of such securities products and are generally registered under the Securities Act of 1933 (“Securities Act”) in order to facilitate their offerings to retail investors. These registered securities are generally offered to retail investors in the form of medium-term or short-term corporate debt with exposure to a variety of asset classes issued by an affiliate of a broker-dealer, and then distributed by that broker-dealer. The issuer of the obligation is typically the parent public company of the affiliated broker-dealer underwriter.

SSPs intended for retail distribution, which are sometimes listed on an exchange, typically have some form of option or other embedded financial derivative exposure. They may be described as offering, among other things, partial or full “principal protection,” higher interest payments, or leveraged and/or asymmetrical exposure to the underlying asset class. SSPs are often quite complex and can present wide-ranging risks and regulatory issues, including suitability and disclosure concerns, limited liquidity, comparatively opaque and often expensive fee structures, paucity of secondary market activity, and difficulty in pricing. They also pose supervisory, compliance and sales training challenges.

Based on the review conducted by OCIE, SSPs are issued and offered in five basic categories with varying payouts and risks.⁴

The most basic category has been referred to as partial or full “principal protected” notes.⁵ Such notes typically have returns linked to broad-based equity indices, such as the S&P 500, Nikkei 225, and Nasdaq. The underlying assets for the majority of the notes described as principal protected notes that we reviewed are typically widely

³ Structured securities products are not currently defined in the federal securities laws. Former Rule 434 under the Securities Act (Prospectus Delivery Requirements in Firm Commitment Underwritten Offerings of Securities for Cash) defined 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.” FINRA Notice to Members 05-59 defines them as “securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or foreign security.”

⁴ These basic forms are often adjusted and/or combined with each other to form numerous types of SSPs.

⁵ As noted later in this report, these notes are “principal protected” only if held to maturity and, of course, are also subject to the creditworthiness of the issuer.

recognized indices such as the S&P or the Russell 2000, although some of the underlying assets could be more esoteric indices or defined baskets. SSPs described as principal protected with full protection tend to have the lowest yields of the SSPs, due to their principal protection component. The basic “principal protected” SSPs might have maturities of five years or more, but they usually have a duration of 6 months to 2 years.

The next category – enhanced-income notes – typically pays a higher coupon base and has capped returns tied to the value/performance of the underlying asset and may include at least some level of “principal protection.” The underlying assets for enhanced income notes typically include single stocks, baskets of stocks, and indices. Enhanced-income notes with indices as the underlying reference are typically coupled with increased principal protection and have longer maturities and lower yields than others. Enhanced-income notes typically have maturities of 5 years or less with the majority having maturities of 1.5-2 years. (The basic “principal protected” notes might have maturities of five years or more, but they usually have a duration of 6 months to 2 years.)

Another category, performance/market participation notes are linked to underlying assets such as gold, or investment strategies, such as long-short strategies,⁶ that are not otherwise easily accessed by small investors.

The fourth category is leveraged/enhanced participation notes that offer a leveraged upside (with a leveraged risk of loss). (For example, the notes may pay a return two to three times the return on the underlying, usually with a cap on the return and no principal protection.

In the fifth category, these basic forms are often adjusted and/or combined with each other to form numerous other types of SSPs, most notably reverse convertible notes (“Reverse Convertibles” or “RCNs”). Reverse Convertibles linked to a single entity are perhaps the riskiest SSPs available to retail investors. Investors are, in essence, purchasing a security with the sale of a put option embedded in it (some call option-SSPs are also offered). The payout for a typical equity-linked reverse convertible note is a high-level interest rate plus a return of principal at maturity if the equity increases in value (or stays the same) over the term of the note. However, if the underlying equity decreases below a set “trigger/knock-in” price at any time during the life of the note (even intraday for some issues) or if the equity closes below the initial level on the valuation date, instead of receiving the principal at maturity, the customer/investor will have “put” to him by the issuer a predetermined number of depreciated shares whose value on the date of maturity is less than the principal amount - while still receiving the coupon payments over the life of the note.⁷ These equity-linked Reverse Convertibles are

⁶ A long-short SSP allows investors to participate in the performance of a leveraged long position of a basket of securities or indices and a short position of a different basket of securities or indices.

⁷ The “trigger/knock-in” price is typically 70–80% of the initial reference level; the initial reference level is typically the closing price of the reference shares on the day the SSPs are priced for initial sale to the public; the valuation date occurs a few business days before the maturity date of notes; and the predetermined number of shares delivered to the investor is equal to 1,000 divided by the initial reference level per \$1,000 principal amount. Some reverse

equivalent to the investor writing/selling a put option on the underlying equity. Such notes lend themselves to being improperly marketed as conservative fixed-income investments when in fact they may be very susceptible to volatile or falling equity prices and may carry considerable risk of loss.

The distribution fees on SSP instruments are upfront sales concessions embedded in the offering price. These vary depending on the complexity of the structure and term of the note. The typical SSP, which might have a maturity ranging from 3 months to three years, might have a fee of one and a half to three percent of the price. (Some longer term-structured products similar to SSPs, such as asset-linked certificates of deposit with maturity dates of five years or longer and the benefit of FDIC insurance may have distribution fees as high as 5% or more.)

II. Current Literature and Resources

In September 2005, the National Association of Securities Dealers (“NASD”), now FINRA, issued **Notice to Members 05-59**, which provides guidance to member broker-dealers concerning the sale of retail SSPs.⁸ The notice was issued because of concern that members may not be fulfilling their sales practice obligations when selling SSPs, especially to retail customers. **Notice to Members 05-59** 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. The Notice highlights the FINRA rules that apply to activities involving SSPs, including **NASD Rule 2210**, which prohibits exaggerated statements and the omission of any material fact or qualification that would cause a communication to be misleading. In addition, the applicable FINRA rules require that materials present a fair and balanced picture regarding both the risks and benefits of the offered product. **NASD Notice to Members 05-59** can be found on FINRA’s website at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p014997.pdf>

More recently, in February 2010, FINRA issued **Regulatory Notice 10-09, Reverse Convertibles**, reminding member broker-dealers of their sales practice obligations with respect to these popular though complex SSPs that feature a high level of risk. In this Regulatory Notice, FINRA reminded firms that sell reverse convertibles to ensure that their promotional materials or communications to the public regarding these products are fair and balanced, and do not understate the risks associated with them. Firms are also reminded to ensure that their registered representatives understand the risks, terms and costs associated with these products, and that they perform an adequate suitability analysis before recommending them to any customer.

convertibles may be structured such that any breach of the trigger or knock-in level may result in the investor receiving less than the original principal regardless of share price at maturity.

⁸ Also, in November 2003 the NASD (FINRA’s predecessor) issued Notice To Members 03-71, concerning member firm obligations when selling “non-conventional investments.” The NASD also issued Notice To Members 05-26 in April 2005, with best practices for reviewing new products, including complex products.

Also in February 2010 FINRA published an investor alert on reverse convertibles, which is available at <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P120883>.

In July of 2007, five trade associations jointly released a set of non-binding principles relating to retail structured products (the ‘RSP Principles’) to guide their members (such as banks, investment banks, broker-dealers and other derivative dealers) in their dealings with each other. The RSP Principles focus primarily on the relationship between firms which are “providers” and “distributors” of SSPs for retail customers. These providers and distributors are the issuers, manufacturers and sellers of retail SSPs.⁹ The RSP Principles are available at <http://www.sifma.org/regulatory/pdf/RSPprinciples0707.pdf>.

III. EXAMINATION OBSERVATIONS

GENERAL OBSERVATIONS

At the larger broker-dealers which underwrite SSPs issued by an affiliate, certain deficiencies and weaknesses were observed during the examinations in the areas of supervision of secondary market trading, disclosures to customers, and training. Based on instances of weaknesses observed at such large broker-dealers, firms should focus on issues such as:

- having adequate procedures and controls in place to prevent and detect possible abuses in the secondary market for SSPs;
- disclosing material facts regarding the SSPs being offered;
- requiring that Registered Representatives (“RR”s) and their supervisors complete specialized training in SSPs prior to selling these products to customers;
- accurately listing SSPs on customer statements;
- having controls to independently review their desk prices of SSPs in the secondary market;
- having controls to adequately review customer suitability;
- having controls to review customer concentrations in the SSPs it sold;
- pre-reviewing transactions in SSPs issued by an affiliate for purchases in ERISA accounts to prevent transactions that may be prohibited transactions.

⁹ The RSP Principles are the product of a working group of their members, taking in the views of both distributors and providers and supported by a coalition of trade associations: European Securitization Forum (ESF), International Capital Market Association (ICMA), International Swaps and Derivatives Association (ISDA), London Investment Banking Association (LIBA) and Securities Industry and Financial Markets Association (SIFMA).

At the smaller, retail broker-dealers the most common area of concern was suitability, especially with respect to the sale of Reverse Convertibles. Training deficiencies were also common. Based on weaknesses seen in these examinations, firms should focus on these issues:

- the suitability of SSP recommendations to retail customers;
- establishing, maintaining and/or enforcing proper supervisory procedures relating to suitability determination for purchasers of SSPs;
- having adequate training for the supervisors and RRs selling SSPs.

DETAILS REGARDING OBSERVATIONS

1. *Customer Suitability*

Customer Specific Suitability

The most significant SSP-related observations made during examinations of retail firms related to suitability with respect to the sale of Reverse Convertibles. There were numerous instances at these firms where the sale of RCNs did not appear to coincide with the customers' stated investment objectives and financial profile. In addition, the firms solicited the purchase of RCNs¹⁰ without adequately disclosing to customers the material risks associated with investing in RCNs. Many of the customers experienced significant losses in these securities as the value of the underlying equity securities diminished. Staff interviews with some of these customers highlighted their apparent lack of understanding of RCNs. Various firms were cited by the staff for violating **NASD Rule 2310(a)** when they made apparently unsuitable recommendations to purchase RCNs. In connection with those unsuitable recommendations, it also appears that some of the firms failed to conduct any sort of supervisory review of the suitability of these recommendations. In particular, it appeared that firms' written supervisory procedures often did not ensure that RCNs were only recommended to persons for whom the risk of such products is appropriate, and that all promotional materials were accurate and balanced as required by **NASD Rule 2210**.

NASD Notice To Members 05-59 states, "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." However, the staff observed that the originating firms examined and most of the retail firms did not have procedures in place consistent with this suggested guideline or take other appropriate steps prior to retail customers' investment in these products.¹¹

¹⁰ See section I for a detailed description of reverse convertible notes.

¹¹ One of the retail firms examined had procedures which required option trading approval for customers who bought SSPs but it did not enforce those procedures.

Concentration Risk

Reports on customer concentrations in SSPs may be a beneficial practice, as the failure of Lehman Brothers and customer losses related to their heavy concentration in Lehman SSPs illustrates.¹² Two of the three originating firms reviewed have monthly exception reports that review for customers' concentrations in SSPs. At both firms, the compliance department is responsible for reviewing these reports. The third firm does not have any customer concentration review procedure in place.

2. Disclosure Documents

For "principal protected" SSPs, the principal protection element only applies if the notes are held until maturity. However, at one firm, the prospectus, including a free-writing prospectus, that offered what was called a ten year 100% principally protected SSP did not disclose the risk that customers may receive less than the principal investment if these notes are redeemed before maturity. Nonetheless, the firm marketed the note as a "100% principally protected structured product." Furthermore, the same firm's secondary market activity in the note revealed that customers who redeemed these products early sold below the principal value. All other SSP prospectuses reviewed for this firm included a disclosure that principal protection only applied if held to maturity.

In the examination of one underwriting firm, the staff noted that the fixed income SSP disclosure documents listed the upfront sales fee (that was included in the offering price) for the underwriting broker-dealer from the affiliated issuer as zero percent. The actual fees paid to the firm on these deals ranged from one and a half to three percent of the deal's total purchase price. Per discussions with the firm, the free-writing prospectuses were updated in September 2007 to disclose these fees on the front cover; however, the final pricing supplement incorrectly still reflected a zero percent fee as late as March, 2008, inconsistent with the free-writing prospectus. Additionally, there was no disclosure in this pricing supplement of the actual fee received by the firm. The staff cited the firm for a violation of NYSE Rule 472(i)(General Standards for All Communications).

3. Customer Account Statement Classification

In its examinations of two other large firms, the staff noted that on customer account statements certain SSPs were inaccurately listed as "Preferred Securities." At one of the firms, there were two SSPs that were inaccurately listed as preferred securities on customer statements. At the other firm, numerous equity-linked SSPs appeared inaccurately under the "preferred stocks" section of customer statements. The classification of SSPs as preferred securities did not accurately reflect the investment characteristics of the particular SSPs. At the first firm, the staff noted two complaints in which customers claimed they were sold SSPs by their RRs under the impression that these were actually preferred stock.

¹² However, a firm may not be able to have a fully reliable way to determine the relative size of a specific customer's risk exposure to SSPs (or to other investments) if that customer has other accounts away from the firm.

4. *Secondary Market Pricing*

SSPs are designed to be held until maturity and thus are not intended to be very active in the secondary market. The secondary market liquidity is often provided solely by the issuer affiliated broker-dealer that underwrote the SSPs. Examiners observed that trading in the SSPs is usually very thin regardless of whether the issue is listed or unlisted. At most firms, their trading desk prices are reviewed by an internal control group, independent of the trading business. However, the staff's review of one firm showed that its traders do not utilize models as a basis for their prices on SSPs and the traders' prices are not reviewed by risk management or any other independent control group. Since this firm is the only one to trade the SSP, a control to ensure that the prices are fair is warranted. The staff cited the lack of an independent review of the traders' prices as an internal control weakness.

5. *Training*

NASD Notice To Members 05-59 states that firms "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 addition, firms "should provide appropriate training to supervisors of registered persons selling structured products." The review of the training materials available at all three firms examined showed that the training information included a description of the product, payout structures, underlying, investment strategy, key risks, and target investors.

Two of the three originating firms examined do not have any training requirements for RRs regarding SSPs. Furthermore, none of the three firms examined have training requirements in place for the supervisors of RRs that market SSPs to their customers. Likewise, numerous retail firm and branch office examinations showed deficiencies in training at both the RR and supervisory level. At the two firms that did not have training requirements, the staff cited the lack of training requirements regarding SSPs as an internal control weakness.

6. *Secondary Market Activity*

Reviews of secondary market activity showed the following sales practice concerns: (1) customers selling SSPs soon after issuance; (2) customers purchasing SSPs soon after issuance and being charged a commission higher than the sales concessions included in the primary offering price; (3) customers selling (and thereby incurring a commission charge) a SSP near payment/maturity date or likely automatic call date¹³ with some sales transactions that settled *after* the payout date; (4) customers "switching" SSPs, which are products designed to be held to maturity in most cases; and (5) purchases effected for customers at prices that exceeded the maximum return price of the SSP at call date. All of the reviews occurred at originating firms. The staff's review of secondary activity in SSPs raised concerns about the sufficiency of supervisory systems in this area at all originating firms examined. Specifically, the following weaknesses/inadequacies in the firms' controls and supervisory systems were noted:

¹³ Automatically callable notes are notes that are called if the underlying asset reaches a certain benchmark on select dates outlined in the prospectus.

- The firms do not review customer transactions soon after issuance;
- The firms do not review customer sell transactions near maturity, especially those that settle on or after payment date;
- The commission charges on secondary activity often greatly exceed sales charges on issuance and the firm's applicable guidelines; and
- The firms do not review secondary activity in SSPs for possible switching, despite the high incentive for RRs to switch customers from one SSP to another.

IV. CONCLUSION

The level of SSPs being sold to retail customers has grown tremendously in recent years and today's low interest rate environment and reduced number of dividend paying stocks makes it more likely that this growth will continue. However, as this Report describes, SSPs present wide-ranging risks and regulatory issues, and they are becoming increasingly complex as evidenced by the large number of Reverse Convertibles being sold to retail customers. SSP sales to retail investors must be tempered by appropriate disclosures of relevant risks. And, as the collapse of Lehman Brothers – a significant issuer of SSPs - has shown, SSPs are also subject to the credit risk of the issuer.

Firms which sell SSPs to retail customers must: acknowledge the unique attributes and risks of these products; tailor their firm's disclosure, supervisory and surveillance functions to address those unique attributes, which include the secondary market concerns detailed in this Report; make a reasonable determination that SSPs are suitable for their customers generally, as well as for each specific customer; and supervise the manner in which SSPs may be marketed to conservative or other investors as suitable, when in fact they may not be suitable. OCIE staff and other regulators will continue to review this area for weaknesses in disclosure, supervision and sales practices, as well as other relevant areas such as are addressed in this Report, and to detect and prevent improper or abusive practices and conduct.