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FINRA Regulatory Notice 10-09 Cautions Brokers on Reverse Convertibles

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FINRA recently outlined the risks of reverse exchangeable securities ("reverse convertibles") and cautioned brokers to make certain their clients are suitable for this type of investment and understand all the risks in acquiring reverse convertibles, including the potential loss of principal.[1]

I. Background

Reverse convertibles are an investment tool created during the 1990s when banks and brokers began offering a large number of innovative structured products to investors. In effect, a reverse convertible involves the investor buying a note with fixed interest payments while selling a put option on the equity interests of a third party. The note provides a return of fixed income similar to bond interest payments. At maturity, the reverse convertible issuer has an option to either repay the note's principal amount in cash or substitute a certain amount of stock (the "Reference Asset") of an unrelated third party entity. The value of the Reference Asset is the corresponding market value at the reverse convertible's maturity. As the embedded put option sold by the investor in the reverse convertible typically only becomes active if the Reference Asset price drops below a certain floor while the reverse convertible is outstanding, the value of the Reference Asset received by the investor when the floor has been triggered is often below the principal amount invested in the reverse convertible.

Due to the uncertain return of principal, reverse convertibles typically pay a larger return relative to many other retail investments as they also reflect elements of the premium to be received by the investor for the put option sold to the issuer. This return has attracted investors during recent years, which has led to a large increase of reverse convertibles offered; issuers released 627 reverse convertible notes in the first seven weeks of 2010, nearly double the amount during such period in 2009.[2] These issuances represented $1.1 billion in 2010 sales, which is nearly triple the amount issued during the first seven weeks of 2009.[3]

II. FINRA Addresses Reverse Convertibles

In response to the expanding market, FINRA recently issued a Notice and an investor alert addressing required disclosure and sales practices for these products.[4] FINRA's statements demonstrate a concern that investors are not being fully informed about reverse convertibles' inherent risks. As such, FINRA stresses increased disclosure and a closer examination of whether the reverse convertible is suitable for an investor's portfolio.

Disclosure

FINRA believes adequate disclosure is essential because "reverse convertibles are complex investments that may be difficult for investors to understand."[5] Therefore the registered representative and the investor should discuss the following:

- An overview of the product's terms, including payment, information about the Reference Asset and, if applicable, that the investor will not receive any appreciation in the Reference Asset's value;
- The fact that the investor may lose the principal value of the investment because it is not guaranteed;
- Reverse convertibles may not be liquid and therefore the investor may not be able to sell the investment prior to maturity or may not receive full value; and
- Finally, if the firm has published research regarding the Reference Asset, the applicability of such research to a recommendation to purchase such reverse convertible.[6]

FINRA Rule 2210 requires communications based on fair dealing and good faith that allow the investor a clear basis to analyze the investment. Such clear communication must be consistent throughout the entire sales process; FINRA stated deficient disclosure in sales materials cannot be cured by a clear outline of the risks in an accompanying prospectus or supplement.[7] Sales material may not suggest that reverse convertibles are ordinary debt or that the credit rating is a definite indicator of the Reference Asset's performance. Further, for any reverse convertibles with maturity shorter than a year, the issuer must ensure that communication clearly provides that the annual yield is not what the investor will receive.[8] Other features the issuer should disclose include tax issues, call risk (if applicable, as some reverse convertibles allow the issuer to redeem the investment prior to maturity), any embedded fees with the investment and any conflicts of interest the issuer may have with respect to the Reference Asset.[9]

Suitability

FINRA also reviewed the process to determine whether reverse convertibles are suitable investments for a particular investor. FINRA Rule 2310 generally provides that prior to recommending a security to an investor, a firm must have a reasonable basis to believe the general suitability of such investment for some investors and the specific suitability for the investor receiving the recommendation. With respect to the general suitability, the firm must understand the risks of the investment, the payment structure, the volatility of the Reference Asset and all credit, market and other risks related to the reverse convertible.[10] With respect to suitability for a particular investor, Rule 2310 requires a review of the investor's investment goals, financial and tax status and any other information reasonably likely to affect the suitability analysis. This analysis must consider the risk of loss and potential volatility and, due to the put option component, whether reverse convertibles should be restricted solely to investors approved for options trading. FINRA's focus on disclosure and suitability was evidenced in a recent action involving H&R Block's reverse convertible program, where FINRA required H&R Block to pay a $200,000 fine and to reimburse an investor who lost money due to insufficient disclosure and lack of suitability.[11]

III. Conclusion

FINRA's guidance is in line with the general market desire for greater risk disclosure with respect to financial products in the retail space.[12] While there has been an increased focus on OTC derivatives and structured finance products that are typically traded by banks and other sophisticated investors,[13] this institutional-type of disclosure and desired transparency relates to the financial risk to institutional market participants and to the capital markets from the default and/or bankruptcy of these sophisticated investors rather than from a need for increased product risk disclosure. Unlike these recent institutional transparency and regulatory initiatives, FINRA's goal is to protect retail investors in reverse convertibles from misleading investment terms.

FINRA's focus is largely in line with the regulation of other investments targeted to retail investors. Securities law, for example, generally requires issuers to disclose all material information related to the investment and its risks to investors to assist in determining whether the investment product is suitable for their portfolio. Regulatory Notice 10-09 affirms that disclosure and suitability standard for the reverse convertibles market. FINRA also clarified that non-disclosure due to a disparity between risk disclosure in the reverse convertible prospectus and the sales documents will result in liability for the issuer and the selling broker.[14]

FINRA's releases provide more clarity with respect to proper issuance, sale and risk disclosure with respect to reverse convertibles. Such releases are consistent with recent FINRA releases[15] and FINRA's view toward structured products generally.[16]

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[1] FINRA Regulatory Notice 10-09—Reverse Convertibles, available at: http://www.finra.org/Industry/Regulation/Notices/2010/P120921; and Reverse Convertibles—Complex Investment Vehicles, available at http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P120883.

[2] Benjamin, Jeff, *Reverse convertible notes warrant sales scrutiny*, Investment News, February 28, 2010, at: http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20100228/REG/302289991/1020

[3] *Id.*

[4] *See* fn 1.

[5] FINRA Regulatory Notice 10-09—Reverse Convertibles, available at: http://www.finra.org/Industry/Regulation/Notices/2010/P120921.

[6] *Id.*

[7] *Id.*

[8] *Id.*

[9] Reverse Convertibles-Complex Investment Vehicles, available at: http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P120883.

[10] FINRA Regulatory Notice 10-09—Reverse Convertibles, available at: http://www.finra.org/Industry/Regulation/Notices/2010/P120921

[11] In that case, a broker advised a retired couple to invest 40% of their savings in reverse convertibles, which FINRA found to be unsuitable for an investor in the couple's position. FINRA Fines H&R Block Financial Advisors US$200,000 for Inadequate Supervision of Reverse Convertible Notes Sales, Suspends and Fines Broker for Unsuitable Sales to Retired Couple, available at: http://www.finra.org/Newsroom/NewsReleases/2010/P120914.

[12] Note that while reverse convertibles are predominantly registered securities, issuers of non-registered reverse convertibles also generally follow disclosure requirements of the securities laws.

[13] *See, for ex.*, *CFTC Chair Gary Gensler Addresses Markit OTC Derivatives Markets Conference*, Wall Street Journal blog, March 9, 2010.

[14] Arguably the reverse convertible's high interest rate is a signal of the product's investment risk and underlying Reference Asset volatility, and therefore disclosure is found under efficient market analysis; in fact, reverse convertibles have consistently priced above the relevant values of the bond and put option components. Szymanowska, Marta, Ter Horst, Jenke and Veld, Chris, *Reverse Convertible Bonds Analyzed*, available at: http://ssrn.com/abstract=730543. However, this concept is undermined by the practice FINRA is specifically targeting, i.e. sales practices that attempt to minimize this correlation between the high return and the reverse convertible's risk.

[15] For example, in December 2009, FINRA released similar guidance for sales of principal-protected notes. See FINRA Regulatory Notice 09-73—Principal-Protected Notes, available at: http://www.finra.org/Industry/Regulation/Notices/2009/P120597.

[16] *See, for ex.*, a release related to structured products in September 2005. FINRA Regulatory Notice 05-59—Structured Products, available at: http://www.finra.org/Industry/Regulation/Notices/2005/P014998.