PUBLICATION

FINRA Requires Enhanced Oversight of Complex Products

Authors: Matthew George White
June 27, 2012

In its 2012 Examination Priorities Letter, the Financial Industry Regulatory Authority (FINRA) highlighted its concern that the current economic environment may make investors more susceptible to recommendations that they chase returns through alternative products which are more complex than everyday equity and fixed-income securities. FINRA identified the following as some of its primary investor protection concerns for retail investors in today's environment:

- **Yield Chasing** – Given the lower yields on Treasuries, FINRA is concerned that investors may inadvertently take risks that they do not understand or that are inadequately disclosed as they chase yields.
- **Liquidity** – The lack of a secondary market for certain securities makes them unsuitable for many retail investors who have strong liquidity needs.
- **Cash Flow Characteristics** – The timing of anticipated cash flows should be in line with investor time horizons.
- **Transparency of Cash Flows and Financial Condition** – Transparent and accurate financial details should be available at the time an investment is made to ensure that investors are making an informed decision. The classification of cash flow returns is particularly important so investors know when returns are being paid from their own principal or from capital raised in subsequent offerings.

Against that backdrop, FINRA issued Regulatory Notice 12-03 (Notice) to identify key features that may render products complex and to assist firms in developing sufficiently robust heightened supervisory systems relative to such products. The fundamental takeaway from the Notice is that complex products should only be recommended after firms have implemented heightened supervisory and compliance procedures that address the various investor protection concerns attendant with recommendations of these products to retail investors. FINRA's overarching concern, and the justification for enhanced oversight, is that retail investors may not have the sophistication or experience to understand the operative features of complex products or appreciate their risks. Thus, it is critical for firms to identify the products they offer that may be considered complex and to have proper procedures and controls in place to ensure they are appropriately scrutinizing transactions in any such products.

Identifying Complex Products

FINRA does not offer an all-encompassing definition of what constitutes a complex product. Instead, FINRA explains that "[a]ny product with multiple features that affect its investment returns differently under various scenarios is potentially complex" and thus subject to enhanced supervision and compliance. A product is more likely to be deemed complex "if it would be unreasonable to expect an average retail investor to discern the existence of these features and to understand the basic manner in which these features interact to produce an investment return" in varying market environments. In providing examples of complex products, FINRA notes that they may include "securities or investment strategies with novel, complicated, or intricate derivative-like features … [that] may make it difficult for a retail investor to understand the essential characteristics of the product and its risks."

According to FINRA, the following securities possess the characteristics described above and, as a result, constitute complex products requiring heightened supervision and compliance:

- Equity-indexed annuities (*see* FINRA Notice 05-50);
- Hedge Funds (*see* FINRA Notice 03-07);
- Asset-backed securities, including those secured by a pool of underlying collateral such as mortgages (*see*, *e.g.*, FINRA Notice 05-59, addressing structured products);
- Unlisted REITs (Real Estate Investment Trusts), which may present liquidity and valuation issues for investors;
- Products that include an embedded derivative component that may be difficult to understand (*see*, *e.g.*, FINRA Notice 10-09, addressing reverse convertible notes);
- Products with contingencies in gains/losses, particularly those that depend upon multiple mechanisms, such as the simultaneous occurrence of several conditions across different asset classes (*e.g.*, range accrual notes);
- Structured notes with "worst-of" features, wherein payoffs depend on the worst performing reference index in a specified group;
- Investments tied to the performance of markets that may not be well understood by many investors (*e.g.*, certain exchange-traded products);
- Products with conditional or partial principal protection (*see* FINRA Notice 09-73, addressing principal protected notes);
- Product structures that can lead to performance that is significantly different from what an investor may expect, such as investments with daily reset return formulas rather than point-to-point returns (*see* FINRA Notice 09-31, addressing leveraged or inverse exchange-traded funds; and FINRA Notice 10-51, addressing commodity futures-linked securities);
- Products with complicated limits or formulas for the calculation of investor gains *(e.g.,* structured notes with payout structures that track the performance of underlying assets up to but not beyond certain pre-set levels).

FINRA stresses that its list of example complex products is not exhaustive and further notes that even some "relatively simple products" might impose substantial risk to investors resulting in the need for enhanced supervision and compliance. In the end, if a product has complex features similar to any of those listed above, firms should err on the side of applying enhanced oversight to the product.

Applying Heightened Supervision and Compliance

Under FINRA's suitability rule, a firm must make both a "reasonable basis" and a "customer-specific" suitability determination before recommending a strategy or product to an investor (*see* NASD Rule 2310; FINRA Rule 2090; FINRA Rule 2111).

To make a reasonable basis suitability determination, a firm must conclude that the strategy or product at issue is appropriate or suitable for at least some investors. To properly draw this conclusion, a firm must undertake "reasonable diligence" regarding the particular strategy or product. The depth of diligence that must be performed, of course, will vary with the strategy or product being reviewed. Thus, the diligence must include consideration of "the complexity and risks associated with the security or investment strategy and the familiarity of the firm or the registered representative with the security or investment strategy." (*See* FINRA Regulatory Notices 11-02 and 11-25.)

To make a customer-specific suitability determination, a firm must conclude that it has a reasonable basis for believing that a particular strategy or product is suitable for the specific customer at issue. In making this determination, a firm must consider certain financial and background information regarding the specific customer, such as his or her age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the firm.

FINRA's Regulatory Notice 12-03 offers guidance as to how firms may satisfy their suitability obligations—both customer-specific and reasonable basis—before recommending complex products to investors. The result is a broad requirement that firms implement specifically tailored and heightened supervisory and compliance procedures that are reasonably designed to ensure that complex products are fully vetted and thereafter recommended only to customers who understand the essential features of the products and for whom the products are suitable.

A firm's procedures related to complex products must, at a minimum, include or otherwise address or provide for the following:

- **Approval of the Sale of Complex Products.** Firms must conduct reasonable diligence in understanding the potential risks and rewards associated with the security or strategy at issue. To gain this understanding, firms must analyze the product's likely performance in a wide range of normal and extreme market conditions. FINRA suggests that firms address at least the following issues/questions before approving the sale of a particular complex product:

  – For whom is the product intended? To whom should the product not be offered? Will distribution be controlled and if so, how?
  – What is the investment objective of the product and is the objective reasonable in relation to the product's characteristics?
  – What assumptions underlie the product and how sound are they? How is the product projected to perform in a wide variety of market or economic scenarios and under what scenarios would principal protection, enhanced yield, or other presumed benefits not occur?
  – What are the risks to investors and do the presumed benefits justify the risks to principal?
  – How will the firm and its registered representatives be compensated for offering the product, and if the compensation structure presents any conflicts with customers, how will the conflicts be resolved?
  – Does the product present any novel legal, tax, market, investment, or credit risks?
  – Does the product's complexity affect suitability considerations or impair understanding and transparency of the product?
  – How liquid is the product and is there an active secondary market for the product?
- **Post-Approval Review.** Heightened supervisory procedures should include a process for periodic reassessments of the product to determine whether its performance and risk profiles have changed, particularly in light of any changes in market conditions.
- **Training of Registered Representatives.** Firms must ensure that the registered representatives who sell complex products are adequately trained to understand all features and risks of the products.
- **Consideration of a Customer's Financial Sophistication.** To comply with the customer-specific suitability obligation, a firm must have a reasonable basis for believing that a particular recommendation is suitable for the customer in light of his or her investment profile and background information. With respect to complex products, FINRA encourages firms to adopt the heightened account approval procedures for opening options trading accounts, which require registered representatives to have a reasonable basis for believing, at the time of making the recommendation, that the customer has knowledge and experience in financial matters such that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the complex product.

- **Discussions with the Customer.** Before recommending a complex product, the firm must thoroughly discuss the features of the product, how it is expected to perform under different market conditions, its risks and possible benefits, and the costs of the product. Firms should also consider whether less complex or costly products could achieve the same objectives.

Conclusion

In conclusion, the sale of complex products is becoming increasingly common in the securities industry and more of these products are being developed and marketed. A firm's decision to sell complex products must be made only after the firm has developed heightened supervisory and compliance procedures to ensure that its registered representatives adequately understand the products and that the products are suitable for the investors for whom they are selected.

If you have any questions regarding these issues or any other securities-related issues, or need assistance in evaluating your company's policies and procedures, please contact any of the attorneys in our Broker-Dealer/Registered Investment Adviser group.