

Regulatory Notice

12-03

Complex Products

Heightened Supervision of Complex Products

Executive Summary

This *Notice* provides guidance to firms about the supervision of complex products, which may include a security or investment strategy with novel, complicated or intricate derivative-like features, such as structured notes, inverse or leveraged exchange-traded funds, hedge funds and securitized products, such as asset-backed securities. These features may make it difficult for a retail investor to understand the essential characteristics of the product and its risks.

The *Notice* identifies characteristics that may render a product “complex” for purposes of determining whether the product should be subject to heightened supervisory and compliance procedures and provides examples of heightened procedures that may be appropriate.

Questions concerning this *Notice* should be directed to Tom Selman, Executive Vice President, Regulatory Policy, at (202) 728-6977.

Background

FINRA often has reminded firms of their obligation to assess the potential risks associated with products that raise specific investor protection concerns. In 2003, FINRA issued two *Notices* addressing the sale of hedge funds and non-conventional instruments to retail investors.¹ In 2005, FINRA issued [*Notice to Members 05-26*](#) (NASD Recommends Best Practices for Reviewing New Products), which recommends best practices for reviewing new products and describes some of the processes that firms use to assess products proposed for sale. Similarly, FINRA has issued *Notices* about equity-indexed annuities,² structured products,³ leveraged and inverse exchange-traded funds,⁴ principal protected notes,⁵ reverse convertibles⁶ and commodity futures-linked securities.⁷ These *Notices* discuss the risks raised by each of these products, including the possibility that the product will not perform as many investors anticipate, or that it might be inappropriately sold on the basis of enhanced yield, principal protection or the tracking of an index or a reference asset. The *Notices* advise firms to adopt procedures for vetting the products and supervising the sale and marketing of the products to retail investors.

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Notice Type

- Guidance

Suggested Routing

- Advertising
- Compliance
- Legal
- Senior Management

Key Topics

- Complex Products
- Due Diligence
- Suitability
- Supervision
- Training

Referenced Rules and Notices

- FINRA Rule 2010
- FINRA Rule 2020
- FINRA Rule 2111
- FINRA Rule 2360
- NASD Rule 2310
- NTM 03-07
- NTM 03-71
- NTM 05-26
- NTM 05-50
- NTM 05-59
- Regulatory Notice 09-31
- Regulatory Notice 09-73
- Regulatory Notice 10-09
- Regulatory Notice 10-22
- Regulatory Notice 10-51



Financial Industry Regulatory Authority

A consistent theme in these *Notices* is that the complexity of a product often necessitates more scrutiny and supervision by a firm. For example, [Notice to Members 05-26](#) encourages firms to consider, during the vetting process, the complexity of a new product, whether the complexity would impair investor understanding of the product, and how complexity would affect the marketing and sale of the product. The *Notice* also encourages firms to consider whether less complex products could achieve the same objectives for investors. The *Notice* states that post-approval follow-up and review may be particularly important for complex products.⁸ FINRA also has brought a number of enforcement actions involving complex products charging inadequate supervision, unsuitable recommendations and misleading sales practices.⁹

In 2010, FINRA issued [Regulatory Notice 10-22](#), which discusses the obligations of broker-dealers that sell Regulation D offerings. The *Notice* reminds firms that FINRA's suitability rule requires that a broker-dealer conduct a reasonable investigation concerning any security that the broker-dealer recommends.¹⁰ The *Notice* also explains that a broker-dealer has a duty to conduct a reasonable investigation about the security and the issuer's representations about it. The duty stems from the broker-dealer's "special relationship" to the customer, and from the fact that in recommending the security, the broker-dealer represents to the customer "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation."¹¹ Failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws and FINRA Rule 2010, requiring adherence to just and equitable principles of trade, and FINRA Rule 2020, prohibiting manipulative and fraudulent devices.

The Securities and Exchange Commission (SEC) also has expressed concern about complex products¹² and has devoted more resources to the issues presented by complex products.¹³ In recent years, the SEC has brought a number of enforcement cases involving complex products, addressing conduct such as the misrepresentation of complex investments as appropriate for retail investors seeking safe investments, fraud in collateralized debt obligation marketing materials, and misrepresentations about the extent to which an investment exposes the owner to the subprime real estate market.¹⁴

European and Asian regulators also have issued policy statements about the sale of complex products by financial firms within their jurisdictions. For example, the Danish Financial Supervisory Authority requires that all investment products sold to Danish retail investors carry one of three labels (green, yellow or red) indicating the risk of losing the initial investment amount and the difficulty in understanding that product.¹⁵ The French Autorité des marchés financiers (AMF) has reminded firms of their marketing and disclosure obligations to investors when dealing with complex products and has established criteria to identify highly complex products.¹⁶ The Financial Services Authority in the United Kingdom (FSA) recently published its new regulatory approach to product intervention, stating that it will place heightened focus on the design, development and management of products.¹⁷ In addition, the FSA published for comment guidance to product providers regarding the

sale of structured products.¹⁸ The Financial Services and Markets Authority in Belgium has temporarily banned on a “voluntary” basis the distribution of any new “unnecessarily complex structured products” to retail investors.¹⁹ The Securities and Futures Commission (SFC) in Hong Kong has adopted a package of measures to strengthen the regulatory regime governing the sale of unlisted structured products and other investments. The regime requires, for example, the issuance of “key fact statements” that summarize the essential features and risks of investment products and a “cooling off” or “unwind” period for investors in certain unlisted structured products.²⁰

Discussion

The fact that a product is “complex” indicates that it presents an additional risk to retail investors because its complexity adds a further dimension to the investment decision process beyond the fundamentals of market forces. This may be the case even though the complexity of some products may arise from features that seek to reduce the probability of investment losses in particular situations. Regulators have expressed concern about complex products because the intricacy of these products can impair the ability of registered representatives or their customers to understand how the product will perform in a variety of time periods and market environments, and can lead to inappropriate recommendations and sales.

Although this *Notice* provides guidance about the characteristics of many complex products, it does not define a “complex product” or provide an exhaustive list of features that might render a product “complex.” Moreover, some relatively simple products may also present significant risks to investors that warrant heightened scrutiny or supervision. Each firm is responsible for determining which products require enhanced compliance and supervisory procedures.

A. Characteristics of Complex Products

Any product with multiple features that affect its investment returns differently under various scenarios is potentially complex. This is particularly true if it would be unreasonable to expect an average retail investor to discern the existence of these features and to understand the basic manner in which these features interact to produce an investment return.

Examples of complex products include the following:

- ▶ Asset-backed securities that are secured by a pool of collateral such as mortgages, payments from consumer credit cards or future royalty payments on popular music, may be difficult for retail investors to understand. With these securities, the creditworthiness of the underlying borrowers or the existence of prepayment risks, though critical to the evaluation of the product, may not be readily apparent to retail investors. Similarly, unlisted REITs may present liquidity and valuation issues for a retail investor.²¹

- ▶ Products that include an embedded derivative component that may be difficult to understand, such as those:
 - ▶ in which repayment of principal or payment of yield depends upon a reference asset, when information about the performance of the reference asset is not readily available to investors. An example is structured notes with an embedded derivative for which the reference asset is a constant maturity swap rate.
 - ▶ that provide for different stated returns throughout the lifetime of the product. For example, “steepener” notes typically offer a relatively high teaser coupon rate for the first year, after which they offer variable rates determined by the steepness of a yield curve. Similarly, some firms have offered structured notes with payoffs contingent on whether one or more reference asset performs within a certain range.
 - ▶ under which the investor might incur a capital loss as a result of the fall in the value of the reference asset without being able to participate in an increase in its value. So-called “reverse convertible notes” may fall into this category.
 - ▶ in which a change in the performance of the reference asset can have a disproportionate impact on the repayment of capital or on the payment of return. For example, “knock in” or “knock out” features associated with reverse convertible notes, in which a drop in the value of the reference asset to a pre-defined level, can affect determination of an investor’s gains or losses.
- ▶ Products with contingencies in gains or losses, particularly those that depend upon multiple mechanisms, such as the simultaneous occurrence of several conditions across different asset classes. An example is range accrual notes for which the return of principal can depend upon the value of two or more reference assets on certain pre-defined dates.
- ▶ Structured notes with “worst-of” features, which provide payoffs that depend upon the worst performing reference index in a pre-specified group. These notes can limit the return of principal at maturity if either the reference index falls by a stated percentage (*e.g.*, 30 percent) or if any of the reference indices decline in value since the date of issue.
- ▶ Investments tied to the performance of markets that may not be well understood by many investors. For example, some exchange-traded products offer retail investors exposure to stock market volatility. Some of these products also provide inverse or leveraged exposure. The investable form of volatility may be in the form of futures on the CBOE Volatility Index (VIX) that reflect the market’s expectation of volatility. Some investors may not understand that the product’s return may not be based on VIX fluctuations actually experienced on a given day, but on the market’s expectation of future volatility.

- ▶ Products with principal protection that is conditional or partial, or that can be withdrawn by the product sponsor upon the occurrence of certain events. Notes that can lose their principal protection based upon a stated event represent an example of a product with this feature.
- ▶ Product structures that can lead to performance that is significantly different from what an investor may expect, such as products with leveraged returns that are reset daily. Leveraged or inverse exchange-traded funds exemplify this feature. Many leveraged and inverse ETFs “reset” daily, meaning that they are designed to achieve their stated leverage or inverse objectives on a daily basis. Their performance over longer periods of time can differ significantly from what might be expected based on their daily leverage or inverse factor.
- ▶ Products with complicated limits or formulas for the calculation of investor gains. For example, some structured notes have a payout structure that tracks the upside performance of a reference asset one-for-four, but if the reference asset’s performance exceeds a specified threshold the payoff is reduced to a much lower, pre-set level, regardless of how it performs afterward.

The list above is not exhaustive. Moreover, many products that do not possess the characteristics described may nevertheless require heightened compliance and supervisory procedures due to the risks they present. However, the general characteristics should assist firms in establishing policies and procedures to identify products that are sufficiently complex to warrant enhanced oversight.

The fundamental point for firms is that if a product has similar features of complexity, such as embedded derivative-like features or a structure that produces different performance expectations according to price movements of other financial products or indices, then firms should err on the side of applying their procedures for enhanced oversight to the product.

B. Heightened Supervision

The following discussion of supervisory and compliance procedures may help firms assess the adequacy of controls with respect to complex products.

Approval of the Sale of Complex Products

Under FINRA’s suitability rule, a firm or registered representative must perform a reasonable basis suitability determination before recommending a transaction or investment strategy involving a security.²² A reasonable basis suitability determination is necessary to ensure that a transaction or investment strategy is suitable for at least some investors (as opposed to the customer-specific suitability determination, which is made on an investor-by-investor basis). To discharge the reasonable basis suitability obligation, a firm or registered representative must perform reasonable diligence to understand the

nature of the transaction or investment strategy, as well as the potential risks and rewards. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of 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.²³

Reasonable diligence must provide the firm or registered representative “with an understanding of the potential risks and rewards associated with the recommended security or strategy.”²⁴ This understanding should be informed by an analysis of likely product performance in a wide range of normal and extreme market actions. The lack of such an understanding when making the recommendation could violate the suitability rule.²⁵ Firms should have formal written procedures to ensure that their registered representatives do not recommend a complex product to a retail investor before it has been thoroughly vetted. Those procedures should ensure that the right questions are answered before a complex product is recommended to retail investors.

These questions should include the following:

- ▶ 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 and is that investment objective reasonable in relation to the product’s characteristics? How does the product add to or improve the firm’s current offerings? Can less complex products achieve the objectives of the product?
- ▶ What assumptions underlie the product, and how sound are they? How is the product expected to perform in a wide variety of market or economic scenarios? What market or performance factors determine the investor’s return? Under what scenarios would principal protection, enhanced yield, or other presumed benefits not occur?
- ▶ What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks to principal?
- ▶ 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?
- ▶ Does the product present any novel legal, tax, market, investment or credit risks?
- ▶ Does the product’s complexity impair understanding and transparency of the product?
- ▶ How does this complexity affect suitability considerations or the training requirements associated with the product?
- ▶ How liquid is the product? Is there an active secondary market for the product?²⁶

Post-Approval Review

A well-designed system of internal controls should include a process to periodically reassess complex products a firm offers to determine whether their performance and risk profile remain consistent with the manner in which the firm is selling them. While a firm's procedures for approving specific complex products will help to ensure that the solicitation of investors is properly supervised, firms also should consider developing procedures to monitor how the products performed after the firm approved them. Every product presents risks that may cause the product to perform differently than anticipated, particularly when market conditions have changed. Some firms require that complex products be formally reviewed for a specific period of time so that the firm can assess their performance and determine whether product limitations are being met and whether market conditions have altered the risks associated with each product. Firms also should conduct periodic reviews to ensure that only associated persons who are authorized to recommend complex products to retail customers are doing so.

Training of Registered Representatives

Registered representatives who recommend complex products must understand the features and risks associated with those products. For example, a registered representative who recommends a collateralized mortgage obligation should understand the various features of the instrument, including the prepayment, credit and liquidity risks associated with the collateral and the particular tranche being recommended. Registered representatives who recommend structured products with embedded options and derivatives should possess a sophisticated understanding of the payoff structure, any limit on upside potential and the risks to investors that the payoff structure presents.

Ideally, the registered representative should be competent to develop a payoff diagram of a structured product to facilitate his or her analysis of its embedded features and recognize that such a product typically can be decomposed into bond and derivative parts. For example, if a structured product promises a 100 percent return of capital at maturity plus 150 percent of any rise in an underlying index over the investment period, the registered representative should have a sufficiently sophisticated understanding of finance to appreciate that this product is similar to a bond that matures with 100 percent return of capital and an embedded call with 150 percent participation and a strike price of 100 percent.

Knowledge of the payoff structure is not equivalent to an understanding of the risks associated with a complex product. The registered representative also should understand such features as the characteristics of the reference asset, including its historic performance and volatility and its correlation with specific asset classes, any interrelationship between multiple reference assets, the likelihood that the complex product may be called by the issuer, and the extent and limitations of any principal protection. The registered representative should be adequately trained to understand not only the manner in which a complex product is expected to perform in normal market conditions, but the risks associated with the product.

Consideration of a Customer's Financial Sophistication

FINRA's suitability rule requires that a firm or registered representative determine that a recommendation to purchase a security is suitable for the particular customer involved. The rule requires that firms and their registered representatives consider, among other factors, a customer's "investment experience" and "risk tolerance" when recommending a securities transaction or investment strategy to the customer.²⁷ In recommending complex products, firms are encouraged to adopt the approach mandated for options trading accounts, which requires that a registered representative have "a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the" complex product.²⁸

Some firms make approval of complex products contingent upon specific limitations or conditions, such as investment concentration limitations or limitations on the type of investors to whom the product may be sold. Some firms prequalify retail investors through specialized investor qualification agreements that may explain the product features and risk in plain English, and often include an attestation that the customer has read the materials provided, understands the risks and wants to invest in the product. The agreement cannot mitigate the responsibility of the firm and the registered representative to conduct a thorough, customer-specific suitability analysis.

Some complex products provide various forms of principal protection. Firms should take reasonable steps to ensure that registered representatives who recommend these products understand the limitations of this protection and the fact that the protection will not alone ensure that the product is suitable for all customers. For example, the existence of the principal protection may not render the product a "conservative investment" for an elderly retail investor for whom safety is an important consideration.

Firms also should consider prohibiting their sales force from recommending the purchase of some complex products to retail investors whose accounts have not been approved for options trading, particularly the recommendation of complex products with embedded options or derivatives. Firms should consider requiring some level of supervision by a specially qualified supervisor of these recommended transactions.

Firms that permit the recommendation of complex products to retail investors whose accounts have not been approved for options trading should develop other comparable procedures designed to ensure that their sales force does not solicit retail customers for whom complex products are unsuitable. These firms should be prepared to demonstrate the basis for allowing their sales force to recommend complex products to retail investors with accounts not approved for options trading. Of course, approving an account for the purchase of complex products is not a substitute for a thorough suitability analysis.

Discussions with the Customer

The registered representative who intends to recommend a complex product should discuss with the retail customer the features of the product, how it is expected to perform under different market conditions, the risks and the possible benefits, and the costs of the product. The registered representative also should discuss the scenarios in which the product may perform poorly. The registered representative should do so in a manner reasonably likely to facilitate the customer's understanding. The registered representative should consider whether, after this discussion, the retail customer seems to understand the basic features of the product, such as the fundamental payout structure and the nature of underlying collateral or a reference index or asset.

Consideration of Whether Less Complex or Costly Products Could Achieve the Same Objectives for the Customer

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

Conclusion

The decision to recommend complex products to retail investors is one that a firm should make only after the firm has implemented heightened supervisory and compliance procedures. Firms should rigorously monitor the extent to which these procedures address the various investor protection concerns raised by the recommendation of complex products to retail investors. Firms also should monitor the sale of these products in a manner that is reasonably designed to ensure that each product is recommended only to a customer who understands the essential features of the product and for whom the product is suitable.

Endnotes

1. [*Notice to Members 03-07*](#) (Feb. 2003) (NASD Reminds Members of Obligations When Selling Hedge Funds); [*Notice to Members 03-71*](#) (Nov. 2003) (NASD Reminds Members of Obligations When Selling Non-Conventional Investments).
2. [*Notice to Members 05-50*](#) (Aug. 2005) (Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities).
3. [*Notice to Members 05-59*](#) (Sept. 2005) (NASD Provides Guidance Concerning the Sale of Structured Products).
4. [*Regulatory Notice 09-31*](#) (June 2009) (FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds).
5. [*Regulatory Notice 09-73*](#) (Dec. 2009) (FINRA Reminds Firms of Their Sales Practice Obligations Relating to Principal-Protected Notes).
6. [*Regulatory Notice 10-09*](#) (Feb. 2010) (FINRA Reminds Firms of Their Sales Practice Obligations With Reverse Exchangeable Securities (Reverse Convertibles)).
7. [*Regulatory Notice 10-51*](#) (Oct. 2010) (Sales Practice Obligations for Commodity Futures-Linked Securities).
8. See generally, [*Notice to Members 05-26*](#) (April 2005) (NASD Recommends Best Practices for Reviewing New Products).
9. See, e.g., *Northern Trust Securities, Inc.* (CRD No. 7927) (June 2, 2011) (inadequate supervision of sales of collateralized mortgage obligations and certain high-volume securities trades); *Santander Securities Corporation* (BD No. 41791) (April 12, 2011) (deficiencies in structured product business and unsuitable reverse convertible sales); *UBS Financial Services, Inc.* (CRD No. 8174) (April 11, 2011) (misleading sales of principal-protected notes).
10. [*Regulatory Notice 10-22*](#) (April 2010) (Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings).
11. *Id.* at 3 (citing *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969)).
12. See Speech by SEC Chairman Mary Schapiro: Keynote Address at the Compliance and Legal Society of the Securities Industry and Financial Markets Association 2010 Annual Seminar, May 6, 2010.
13. See Testimony on the President's FY 2012 Budget Request for the SEC by Chairman Mary Schapiro, Before the United States Senate Subcommittee on Financial Services and General Government, Committee on Appropriations, May 4, 2011.
14. See Speech by SEC Chairman Mary Schapiro, *supra* n.12.
15. See Danish Ministry of Economic and Business Affairs [*Executive Order No. 345*](#) on Risk-Labeling of Investment Products (April 15, 2011).
16. See AMF Position No. 2010-05-15, [*Marketing of complex financial instruments*](#), October 2010.
17. See FSA Discussion Paper DP 11/1, [*Product Intervention, January 2011*](#). See also [*FSA Feedback Statement FS 11/3 \(feedback on DP 11/1\)*](#), June 2011.
18. See [*FSA Guidance Consultation, Retail Product Development and Governance - Structured Products Review, November 2011*](#).
19. See Financial Services and Markets Authority Communication 2011_02, [*Moratorium on the Distribution of Unnecessarily Complex Structured Products, June 2011*](#), updated [*September 2011*](#).

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20. See SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (Handbook), Section I: Overarching Principles, Chapter 6: Disclosure Requirements, Product Key Facts Statements, Sub-sections 6.5-6.8 and Handbook Part IV: Post-sale arrangements – cooling-off period, Chapter 8: Issuer to provide for cooling-off or unwind right, Sub-sections 8.1-8.6.
21. In [Regulatory Notice 11-44](#), FINRA proposed amendments to NASD Rule 2340 to address how firms report the per share estimated values of unlisted Direct Participation Programs and unlisted REITs on customer account statements.
22. FINRA Rule 2111 takes effect on July 9, 2012. Pending effectiveness of that rule, NASD Rule 2310 governs the suitability obligations of a broker-dealer.
23. FINRA Rule 2111.05(a).
24. *Id.*
25. *Id.*
26. See also [Notice to Members 05-26](#) (April 2005).
27. FINRA Rule 2111(a).
28. FINRA Rule 2360(b)(19)(B).