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Steering Clear of Merit-Based Regulation for Complex Securities Products

By Michael A. Nagy, Esq.

KEY POINTS:

- Complex investment products have grown in importance as retail customers search for yield and broker-dealer firms look for innovative products to meet this demand and generate revenue.
- Although there is no legal definition for the term "complex product," an investment may be deemed complex if the average retail investor probably will not understand how its features will interact under different market conditions, and how that interaction may affect risk and return.
- FINRA has recently declared that some form of product approval, or "merit regulation", may become inevitable if the industry and regulators are unable to demonstrate their ability to control sales practice abuses relating to complex products.
- There are several steps a broker-dealer firm can and should take to consider whether it should sell a complex product to retail customers, and to ensure proper supervision of its registered representatives.

Benjamin Franklin famously advised that "an ounce of prevention is worth a pound of cure." His famous saying was actually firefighting advice. Fires were an exceptionally dangerous threat to Philadelphians, and those who suffered fire damage to their homes often suffered irreversible economic loss. Franklin set about trying to remedy the situation. In 1736, he organized Philadelphia's Union Fire Company, the first in the city. Franklin, having been to other cities that were better prepared, encouraged the formation of a formal society of well trained and dedicated firefighters. The process was adopted and Philadelphia's firefighters became more effective with good training and organization. Franklin's "ounce of prevention" philosophy resulted not only in the establishment of the Union Fire Company, but also led to education for the general public about fires and firefighting. This organized prevention and education transformed Philadelphia from an unsafe city to one of the safest cities in America for fire prevention.

Franklin's adage about "an ounce of prevention" is as true today as it was in the 1700s. It is particularly true in the brokerage industry given the current economic and regulatory environment. Indeed, Franklin's sentiment was recently echoed by Richard G. Ketchum, Chairman and Chief Executive Officer of FINRA, in his speech to the industry about regulation of complex investment products and the future of the securities industry if broker-dealer firms fail to get it right.

On September 27, 2012, Mr. Ketchum spoke at the SIFMA Complex Products Forum in New York, NY. His remarks highlight what broker-dealer firms can do to ensure that complex investment products are vetted, registered representatives are trained and supervised, and risks are disclosed in a way that the average investor can understand. Mr. Ketchum's comments are instructional, particularly in light of FINRA's Regulatory Notice 12-03 (Heightened Supervision of Complex Products), the slew of SEC enforcement actions involving complex products, and the considerable amount of private litigation against firms and registered representatives. Mr. Ketchum also provided insight into FINRA's view on the possibility of merit-based regulation of investment products. His comments are evocative of Franklin's prudent observation about fire prevention. Coincidentally, his speech also suggests that the age-old idiom "where there's smoke there's fire" may appropriately describe the complex securities market today.

In the United States, the securities industry is not subject to "merit" regulation. In other words, federal regulators do not deny retail investors the opportunity to invest in risky or complicated products. Rather, federal securities laws require that issuers and intermediaries disclose the risks associated with securities, and FINRA requires that firms supervise the recommendations of their registered representatives. Other countries, however, have recently taken a different approach by implementing a form of merit regulation in which certain speculative products are prohibited from reaching the retail market. Notwithstanding that this approach is a significant departure from the product disclosure model on which our federal securities laws are based, FINRA recently declared that some form of product approval may be inevitable in the United States if the industry and regulators are unable to demonstrate their ability to control sales practice abuses relating to complex products.

FINRA has often reminded firms of their obligation to assess potential risks associated with products that raise specific investor protection concerns. FINRA has issued Regulatory Notices addressing the sale of hedge funds; equity-indexed annuities; structured products; leveraged and inverse exchanged-traded funds; principal protected notes; reverse convertibles; and commodity futures-linked securities. These Notices advise firms to adopt procedures for vetting the products and supervising the sale and marketing to retail investors. A consistent theme is that the complexity of a product often necessitates more scrutiny and supervision.

FINRA has recently 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 run-of-the-mill equity and fixed-income securities. Against that backdrop, FINRA issued Regulatory Notice 12-03 to provide guidance about supervision of complex products. Mr. Ketchum's latest remarks reinforce the heightened supervision requirement for complex products.

Under FINRA's suitability rule, a firm or registered representative must perform a "reasonable basis" and "customer-specific" suitability determination before recommending a transaction or investment strategy. FINRA's Regulatory Notice 12-03 offers guidance as to how firms may satisfy their suitability obligations before recommending complex products to investors.

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 formal procedures should ensure that the right questions are answered before a complex product is recommended to retail investors. According to FINRA, these questions should include the following, among others:

- For whom is the product intended, and to whom should it be offered?
- Is the product's investment objective reasonable in relation to the product's characteristics?
- Can less complex products achieve the same objectives?
- What assumptions underlie the product, and are they sound?
- What factors determine the investor's return?
- What are the risks for investors?
- Does the product present any novel legal, tax, market, investment or credit risks?
- How does complexity affect suitability considerations or training requirements?
- How liquid is the product, and is there an active secondary market for it?
- How will the firm and registered representatives be compensated?

In addition to answering these questions, firms should do the following to ensure proper supervision of complex products at every stage of the selling process:

- Periodically reassess complex products to determine whether their performance and risk profile remain consistent with the manner in which the firm is selling them;
- Monitor how the products performed after the firm approved them;
- Conduct training to ensure registered representatives understand the features and risks associated with complex products;
- Consider making approval of complex products contingent upon specific limitations or conditions, such as investment concentration limitations;
- Consider prequalifying retail investors through specialized investor qualification agreements that explain the product features and risks in plain English;
- Require an attestation that the customer has read the materials provided, understands the risks, and wants to invest in the product;
- Consider requiring some level of supervision by a specially qualified supervisor; and
- Develop procedures designed to ensure that registered representatives are not soliciting retail customers for whom complex products are unsuitable.

FINRA recognizes that the complexity of certain products does not make them inherently unsuitable. However, FINRA has made it clear that the decision to recommend complex products to retail investors is one that a firm should make only after it has implemented heightened supervisory and compliance procedures. Firms must rigorously monitor the extent to which their procedures address the various investor protection concerns related to complex products, and firms should implement procedures to ensure that complex products are recommended only to customers who understand the essential features and for whom the product is suitable. This "ounce of prevention" is most certainly worth "a pound of cure", especially if the alternative is merit-based regulation resulting in prohibition of complex products from reaching the retail market.

Like the citizens of Philadelphia who transformed their city from a fire hazard to one of the safest in America for fire prevention, firms have been tasked with transforming the market for complex products from one of sales practice abuse and inadequate safeguards to one of steadfast compliance, heightened supervision, and full disclosure. To that end, firms would be wise to heed FINRA's warning to implement and carry out certain time-consuming and costly measures now, or the consequences of not doing so may prove to be far more painful and costly in the future. Only then will the smoke clear from the complex products market and merit-based regulation in the United States can be relegated to the scrap heap of threatened regulations which never came to pass.