



## FINRA Provides a Reverse Convertibles Reminder

In response to controversial sales practices relating to reverse exchangeable securities (“reverse convertibles”), FINRA recently issued two documents— a Regulatory Notice<sup>1</sup> and an Investor Alert<sup>2</sup>—on reverse convertibles. Among other issues, the documents address potentially abusive sales tactics relating to sales of reverse convertibles, such as emphasizing high interest rates and deemphasizing the lack of principal protection.<sup>3</sup> The key takeaway is that reverse convertibles are complex instruments and, given the potential for investor confusion, brokers should ensure that they offer the notes only to appropriate investors and that they supply those investors with adequate disclosure.

### Adequate Disclosure

FINRA refers to NASD Rule 2210 as a guidepost for the quality of disclosure.<sup>4</sup> Rule 2210 directs firms to ensure that their communications with the public be “based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service.”<sup>5</sup> In FINRA’s view, Rule 2210 requires brokers that sell reverse convertibles to make the following disclosures:

- an explanation of how the instrument functions, including payout structure, relevant information about the underlying asset, and (if applicable) that the investor will not participate in any appreciation in value of the underlying asset;
- that repayment of principal is not guaranteed and that the investor may suffer a loss on the investment;
- that the investor may not be able to sell the reverse convertible prior to maturity unless the issuer or a third party creates and maintains a secondary market for the instruments; and
- that the broker has (or has not) published its own research about the underlying asset and the extent to which that research is or is not applicable to the investor’s decision to purchase the reverse convertible.

<sup>1</sup> FINRA Regulatory Notice 10-09—Reverse Convertibles, available at <http://www.finra.org/Industry/Regulation/Notices/2010/P120921>. (“Regulatory Notice”).

<sup>2</sup> Reverse Convertibles—Complex Investment Vehicles, available at <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P120883>.

<sup>3</sup> The facts surrounding H&R Block’s recent settlement serve as a useful example of these issues, and were part of the impetus of FINRA’s recent announcements. See FINRA Fines H&R Block Financial Advisors \$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>.

<sup>4</sup> Regulatory Notice, page 5.

<sup>5</sup> NASD Rule 2210.

The Regulatory Notice also provides a few examples of poor disclosure practices for reverse convertibles, several of which have been reported by the media in recent years:

- suggesting that reverse convertibles are ordinary debt securities;
- suggesting that the relevant issuer's credit rating<sup>6</sup> reflects the expected performance of the reference asset;
- exaggerating the probability that the investor will receive a full return of principal; and
- presenting annualized coupon information in a misleading manner, such as overemphasizing the annualized yield for a security that has a maturity of less than a year.

In short, much of FINRA's guidance for adequate disclosure hews closely to the required disclosures for sales of other types of non-principal protected structured notes. However, issuers and underwriters of reverse convertibles are likely to reassess their prospectuses and other offering documents for these securities to ensure that they comply with FINRA's guidance.<sup>7</sup>

### Suitability

FINRA's guidance with respect to suitability is based on NASD Rule 2310, which requires (a) that any given product is suitable for at least some investors and (b) that brokers have a reasonable basis for determining that a product is suitable for a specific investor before making an offer.<sup>8</sup> In particular, brokers must make a reasonable effort to determine the customer's financial status, tax status, investment objectives and such other information that is considered reasonable in making investment recommendations to a customer. In determining whether the instrument is appropriate for the investor, the broker should consider the potential volatility of the underlying asset, the risk that the investor will receive less than full repayment of principal upon maturity, and any other risks and costs inherent to the instrument.

Especially in light of the put option that is embedded in a typical reverse convertible structure, FINRA also suggests that brokers may consider restricting sales of reverse convertibles to customers whose accounts have been approved for options trading. If a firm does not opt to limit sales to those accounts, it should be prepared to demonstrate its basis for allowing investors who are not approved for trading options to purchase reverse convertibles. This concept had been introduced previously by FINRA in its 2005 Notice to Members 05-59.<sup>9</sup>

### Supervision

The Regulatory Release reminds member firms that (a) they are required to maintain supervisory procedures and controls that are designed to ensure that sales of these securities will comply with the federal securities laws and applicable FINRA rules and (b) they must adequately train employees who sell these securities. Ultimately, even the most carefully crafted disclosure documents will not keep a broker out of trouble if individual brokers are not correctly selling these securities.

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FINRA's recent releases do not introduce any additional requirements on brokers who sell reverse convertibles. However, they do serve as a useful reminder to brokers that existing requirements will be carefully enforced.

<sup>6</sup> Issuers of reverse convertibles typically have an investment grade rating for their senior debt securities.

<sup>7</sup> The Regulatory Notice, page 6, reminds member firms that deficient disclosure in their sales materials cannot be cured through adequate disclosure in the statutory prospectus for the securities. That is, although the totality of the disclosure documents may be sufficient for purposes of the U.S. federal securities laws, each offering document used by a member firm should be consistent with FINRA's disclosure requirements.

<sup>8</sup> Regulatory Notice, page 6.

<sup>9</sup> FINRA, Notice to Members 05-59, available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p014997.pdf>.

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