

FOLEY'S MARKET REGULATION SERIES

Complex Products: Adapting to a Hostile Environment



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Panel



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Introduction



- “[W]e intend to focus our examination efforts on Suitability and **Complex Products**.”

– 2013 FINRA Examination Priorities

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What are Complex Products



- Products with
 - Optionality or embedded derivatives
 - Leverage
 - High yield
 - Secured by a pool of collateral
 - Complicated limits or formulas
 - See FINRA Regulatory Notice 12-03

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Examples



- Non Traditional ETFs—inverse and leveraged
- Principal Protected Notes
- Market linked CDs
- Commodity Futures-Linked Securities
- Reverse Convertibles
- REITs

Regulatory Notices



- FINRA Notices
 - Notices to Members, Regulatory Alerts, FAQ, and Investor Alerts
- FINRA Targeted Examination Letters
- SEC Notices
- 2013 OCIE and FINRA Examination Priority Letters

Areas of Concern



- Investor understanding of terms
- Risk/return
- Market risk
- Credit risk
- Liquidity
- Disconnects between customer expectations and risk tolerance

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Suitability



- NASD Rule 2310 (old rule)
- FINRA Rule 2111 (new rule)
 - Reasonable Basis Suitability
 - Customer-based Suitability
 - Is there a less costly alternative
- Applying the new rule to old conduct

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Summary of Enforcement Activity



There has been noteworthy enforcement activity with respect to complex products.

- FINRA, SEC and various states have brought matters involving a variety of complex products
- These matters typically involve sales practice/suitability, supervision, systems and procedures, and training
- Settlements have resulted in fines in the low to high seven figure range and generally include a restitution component for affected customers with conservative risk profiles and investment objectives

Summary of Enforcement Activity



FINRA settlements involving large firms--

- \$2.5 million fine and \$8.25 million in restitution arising from the sale of Lehman Brothers principal protected notes
- \$1.7 million fine and restitution of \$1.9 million arising from the sale of UITs and Floating rate loan funds
- \$2 million fine and unspecified restitution for unsuitable transactions and missed breakpoints or credits
- Fined a large firm for the sale of reverse convertibles and UITs
- Four firms fined and ordered to pay \$9.1 million in restitution arising from the sale of non traditional ETFs

Lessons Learned



- Due diligence
- Training—a shield (in the firm’s hand) and a weapon (in the hands of the regulator)
- Systems
- Supervision

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Questions?



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