9.25 Structured Products

Structured products generally are securities that are derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign security. There are many variations of structured products and different features such as principal protection; payment of interest above market rates; and capping upside participation. Structured products have a fixed maturity, and some may be listed while others are thinly traded.

Structured products typically have two components, a note and a derivative (often an option). The note pays interest at a specified rate and interval while the derivative establishes the payment at maturity. Structured products are generally subject to the requirements for public offerings of securities under the '33 Act and are usually offered from a shelf registration.

Principal-protected notes are discussed in a specific subsection.

Suitability and Best Interest

Because of the potential complexity of structured products, RRs must determine the suitability or best interest (as applicable) of potential purchasers, including the customer's:

- financial situation including income and liquid net worth
- age
- investment experience
- ability to bear the risks involved with the product
- knowledge and experience in financial matters that the customer can be reasonably expected to be capable of evaluating the risks of the recommended transaction

RRs should inform the customer of the features of the structured product being recommended. RR's will be required to pass specific modules prior to recommending any of these structured products

Risk Disclosure

It is important that investors understand the risks involved in structured product investments. If a prospectus or risk disclosure statement is available for the product being offered, it must be provided prior to any purchase. RRs must discuss the following risks with potential individual investors:

- General types of risks associated with structured products
- Any risk not usually associated with a given product, such as risk of loss due to any sale of the product before maturity
- Any material product-specific risk such as risks arising from the underlying asset, liquidity and market risks in relation to the product itself, or specific tax considerations
- Acknowledgment of limitations on available data
- The distinction between the underlying asset and the structured product based on the asset
- For principal-protected products, that the principal protection applies only at maturity and the costs of unwinding the product mean an earlier redemption value which may differ significantly from maturity value

- Availability or lack of availability of a secondary market to liquidate the investment
- Sales in the secondary market may be at significantly discounted value to the original investment
- Tax implications (if applicable) and the potential need to consult with the investor's accountant, tax attorney, or other tax professional

Fees and Costs

Fees, costs, commissions, discounts, and any other amounts paid at the time of purchase or for acting as such, over the life of that product, must be disclosed to investors.

Credit Ratings

Credit ratings of issuers (or guarantors) may not represent a rating of the structured product. If credit ratings are disclosed to potential investors, disclosure must make clear the significance of the rating in relation to the investment.

Tax Implications
Investment in structured products may have tax consequences for individual investors depending on their personal circumstances and jurisdiction of residence. Although certain tax implications may be highlighted in product documents, investors should be encouraged to discuss the specific tax implications of structured products with their accountant, tax attorney, or other tax professional.

Features and Risks of Structured Products

Each structured product will have different features and it is the RR's responsibility to understand those features before making a recommendation. Following are some features that must be communicated to the customer (depending on the product) before a structured product is purchased:

- **Principal protection:** Some products offer full upside protection or have a cap; no dividends are paid. Principal protection may mature within one to seven years and investors must hold them until maturity to guarantee the principal's return. Maturities shorter than 5 years usually cap returns.

- **Buffered return-enhanced notes:** Usually linked to the performance of a market index and issued as senior unsecured debt obligations that mature within one to five years and trade in $1,000 increments. There is no dividend or interest income and gains are taxed as long-term capital gains if the investment is held un-hedged for more than one year. Buffered notes provide partial principal protection with the buffer ranging from 10% to 15%.

- **Return-enhanced notes:** The investor gives up the right to participate in market gains over a period in exchange for a payout at maturity that may be 2 or 3 times the return of a benchmark index. Maturities generally range from 1 to 3 years and trade in $1,000 increments. They have a cap and provide no protection against market declines, and there is no dividend income.

- **Reverse convertibles:** This product is linked to a particular stock, basket of stocks or index and pay a fixed coupon that provides some protection from loss. The registered notes mature within one year or less and trade in $1,000 increments. They typically carry a coupon of between 10% and 20% and the upside is limited to the coupon amount. If the underlying stock falls below a set "barrier" level, the investor may get significantly lower-valued stock instead of cash upon maturity. If the underlying stock is volatile, risk is significantly increased. Investors who try to sell a reverse convertible before maturity may lose money since there may not be much demand for the notes, especially in a down market.

Principal-Protected Notes (PPNs)
[FINRA Regulatory Notice 09-73; SEC Investor Alert: http://sec.gov/news/press/2011/2011-118.htm]

PPN in this section refers to any structured product that combines a bond with a derivative component and that guarantees a full or partial return of principal at maturity. Sales of PPNs to retail customers are subject to particular considerations explained in this section:

- While products may be described as "guaranteed," principal protection, absolute return, minimum return, the degree of guarantee, protection, risk, and return vary depending on the specific features of the note being sold.

- The suitability or best interest (as applicable) of recommendations must take these features into consideration as well as the customer's objectives, needs, and willingness/ability to sustain risk.

Features of PPNs

PPNs typically combine a zero-coupon bond with an option or other derivative product with a payoff linked to an underlying asset such as an equities index or basket of indices. There is a guarantee of a return of some or all principal at a maturity date which may be up to 10 years from issuance and participation in a return linked to a specific change in the value of the underlying asset.

RRs should review FINRA Regulatory Notice 09-73 for illustrations of how returns and guarantees may vary depending on how the note is structured.

Suitability and Best Interest Considerations

The following are factors to consider when recommending PPNs.

- The creditworthiness of the guarantor and the nature and terms of guarantees
- The investment's pay-out structure, costs and fees
- The customer's need for access to their money before the maturity date arrives or a lock-up period expires
- The call risk of callable notes
- Tax consequences such as a note invested in zero-coupon bonds which could result in paying tax on imputed interest as it accrues

- Fees and costs
- Lack of inflation protection since principal guarantee generally relates to nominal principal

Reverse Convertibles
[FINRA Regulatory Notice 10-09]

A reverse convertible is a structured product that has features that should be communicated to potential retail investors before recommending the security. Relevant features potentially include the following:

- **How the product works** including pay-out structure, relevant information about the reference asset, and, if applicable, that the investor will not participate in any appreciation in the value of the reference asset.
- **Return of principal.** Instead of a full return of principal at maturity, the investor could receive less than a full return of principal if the value of the reference asset has fallen below a certain level, often referred to as the "knock-in" or "barrier" level. Depending on the underlying asset, the investor could receive a predetermined number of shares of common stock (or cash equivalent), which would amount to less than the investor's original investment.
- **Pay-out structure.** Pay-out structures may involve multiple variables that affect risk, cost, and potential benefits. The RR should have an understanding so these variables may be communicated to the investor.
- **Sale of product prior to maturity.** The ability to sell and the potential selling price may depend on the willingness of the issuer or another party to maintain a secondary market.

Communications, whether directly with a potential investor or through advertising or other communications, must be truthful and not contain any exaggerations. Following are restrictions and guidelines on communications:

- Reverse convertibles should **not** be described as ordinary debt securities.
- Any reference to the product's credit rating cannot suggest that the rating has any bearing on the expected performance of the reference asset, nor may it exaggerate the probability that the investor will receive a full return of principal.
- Annualized yield or coupon information cannot be presented in a misleading manner. For example, a 10% per annum coupon provides an actual return of roughly 2.5% (based on a 360-day year) over a 3- month term. Communications about products that mature in less than a year must balance communication about annualized yield with prominent disclosure of the actual percentage return and the term of the note.

Exchange Traded Notes (ETNs)

[FINRA Investor Alert: http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/TradingSecurities/P131262; NYSE Informed Investor: What You Should Know About Exchange Traded Notes]

ETNs are unsecured debt obligations of an issuer which typically is a bank or another financial institution. RRs must be familiar with the features and risks of ETNs before recommending them, and explain features to prospective investors. The complexity of an ETN is a factor to consider before recommending it to an investor.

Features include the following:

- ETNs are sold by prospectus which must be provided to the investor.
- ETNs usually do not pay interest but rather make distributions determined by the performance of an underlying index or benchmark on the ETN's maturity date (which may be 10, 30, or 40 years from issuance) minus fees. An individual ETN may or may not provide for periodic payments or cash distributions prior to maturity.
- Underlying indexes may be familiar and broad-based or less familiar asset classes or complex and sometimes proprietary indexes.
- Some ETNs offer leveraged exposure to the index or benchmark they track.
- Leveraged and inverse ETNs are short-term trading investments not intended for long-term investing.
- The creditworthiness of the issuer is important since the ETN itself is not rated.
- ETNs may have a repurchase feature allowing qualified investors to redeem notes of a minimum denomination or value daily or weekly at a predetermined price. Other investors may sell in an available secondary market (ETNs are often listed), sell if called by the issuer, or allow them to mature.
- The issuer charges an annual fee through the term of the ETN. Fees are explained in the prospectus.
- ETNs trade on exchanges; the sales price in the secondary market is determined by supply and demand. ETNs do not sell at net asset value (NAV).

Risks include:

- As unsecured debt obligations, the issuer may default on the note.

- ETNs are influenced by the value of the underlying index subjecting the investor to market risk.
- A trading market may not develop, even though an ETN is listed on an exchange.
- An ETN's market price may not track the underlying index.
- Some ETNs (particularly some leveraged, inverse and inverse leveraged) are short-term trading tools that may reset daily. The performance of these products over long periods can differ significantly from the stated multiple of the performance (or inverse performance) of the underlying index or benchmark.
- ETNs containing components traded in foreign currencies are subject to foreign currency exchange risk.
- Some ETNs are callable at the issuer's discretion; the notes may be called when the investor may incur a loss.
- The issuer may engage in trading activities at odds with investors who hold the notes.

Supervisory Review Procedures and Documentation

Designated supervisor will review product offering documentation and fact sheets. On an as needed basis or at the time of subscription, supervisor will review client account information for suitability and concentration. Supervisor may confirm registered rep training on any third party vendors if applicable.