NATIONAL EXAM PROGRAM
RISK ALERT

By the Office of Compliance Inspections and Examinations ("OCIE")[1]

Volume IV, Issue 7 **August 24, 2015**

This Risk Alert summarizes deficiencies that OCIE staff observed in the controls that certain broker-dealers put in place to comply with obligations related to sales of structured securities products ("SSPs") to retail investors, including 1) controls related to determining suitability of SSP recommendations and 2) written supervisory procedures related to reviews of representatives' suitability determinations with regard to SSPs.

BROKER-DEALER CONTROLS REGARDING RETAIL SALES OF STRUCTURED SECURITIES PRODUCTS

I. Introduction

OCIE's National Examination Program staff (the "Staff") examined ten branch offices of registered broker-dealers (the "broker-dealers" or "firms") that distribute structured securities products ("SSPs") issued by their parents or affiliates or issued by unaffiliated third parties.[2] Using data analytics, the Staff assessed these firms' compliance with suitability and supervision requirements in the Securities Exchange Act of 1934 ("Exchange Act") and evaluated whether the firms effectively supervised and monitored activities and risks associated with sales of SSPs to retail investors. The Staff's analysis of the implementation of controls across the branch offices of each firm revealed discrepancies in the practices within each firm and discrepancies in the effectiveness of the controls. Firms should note the importance of the implementation of controls as well as their design on the effectiveness of such controls.

SSPs are securities, often issued as corporate obligations of an affiliate of the underwriting broker-dealer. They derive their value from, and provide exposure to, a variety of underlying asset classes such as a single security, baskets of securities, indices, options, commodities, and/or foreign currencies. SSPs, which may or may not be listed on an exchange, typically have some form of embedded derivatives and may supply, among other things, principal protection, interest payments, or leveraged exposure to the referenced assets. This Risk Alert focuses on structured notes in particular.[3]

1 The views expressed herein are those of the staff of OCIE, in coordination with other staff of the Securities and Exchange Commission ("SEC" or "Commission"), including the Division of Trading and Markets. The Commission has expressed no view on the contents of this Risk Alert. This document was prepared by the SEC staff and is not legal advice.

2 The examinations described in this Risk Alert did not cover exchange-traded products.

3 Structured notes are structured products that are comprised of a debt obligation and at least one embedded derivative.

During these examinations, the Staff analyzed, in aggregate, over 26,600 sales of SSPs, totaling over $1.25 billion in principal transactions.[4] By reviewing the account documentation of customers engaged in these transactions, including data on risk tolerance and investment objective, age, and any approval for options trading, the Staff was able to identify, on an aggregate basis, the predominant types of customers that had purchased SSPs at each firm and branch office. The Staff also reviewed resales of SSPs in these accounts in order to gauge the frequency and price at which SSPs were resold prior to maturity. Finally, the Staff analyzed the frequency with which each firm's transactions exceeded internal policies and procedures governing suitability of recommendations to brokerage customers as well as supervisors' documentation approving overrides of internal suitability guidelines with respect to suitability of recommendations.

Among other things, the examinations revealed several significant deficiencies in the areas of suitability and supervision with respect to all of the examined firms' sales of SSPs to retail investors. Specifically, all of the examined firms:

- Failed to maintain and/or enforce adequate controls relating to determining the suitability of SSP recommendations; and

- Failed to conduct both compliance and supervisory reviews of registered representatives' ("representatives") determinations of customer suitability in the SSPs, as required by their internal controls.

II. Overview of Broker-Dealer Obligations Regarding Sales of SSPs

A. SSPs

SSPs have been increasingly marketed to retail investors, who have been interested in generating income in the low-yield interest-rate environment that has persisted since the financial crisis. Additionally, SSPs may offer attractive attributes such as partial or full "principal protection" or exposure to a particular asset class. SSPs often provide for payments determined by reference to other assets or indices and may be more complex than a simple debt instrument with a stated interest rate.[5]

B. Suitability and Supervision Requirements

A central aspect of a broker-dealer's duty of fair dealing is the suitability obligation, which generally requires a broker-dealer to make recommendations that are consistent with the best interests of its customer.[6] The concept of suitability has been interpreted as an obligation under

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4 The review period for these examinations included the period of January 1, 2011 to December 31, 2012, unless indicated otherwise herein.

5 For additional information on structured products and trends indicating increased sales to retail investors, *see* OCIE's "Staff Summary Report on Issues Identified in Examinations of Certain Structured Securities Products Sold to Retail Investors" (July 27, 2011).

6 *See, e.g.*, *In the Matter of the Application of Raghavan Sathianathan*, Exchange Act Release No. 54722 at 21 (Nov. 8, 2006) ("NASD Conduct Rule 2310 requires that, in recommending a transaction to a customer, a

the antifraud provisions of the federal securities laws[7] and also appears in specific SRO rules.[8] As part of its suitability obligations for complex products, FINRA encourages firms to require that a registered representative has a reasonable basis to believe 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."[9]

The FINRA rules also require broker-dealers to supervise their associated persons, and the Exchange Act permits the Commission to sanction broker-dealers who fail reasonably to supervise, with a view to preventing violations of the federal securities laws by a person subject to their supervision.[10] In addition, FINRA has released guidance to help assess the adequacy of controls with respect to SSPs and complex products that members should include in their supervisory and compliance procedures, such as provisions relating to a reasonable basis

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registered representative 'shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.' As we have frequently stated, a broker's recommendations must be consistent with his customers' best interests.") (citations omitted). *See also* *In the Matter of the Application of Dane S. Faber*, Exchange Act Release No. 49216 at 23-24 (Feb. 10, 2004) ("Before recommending a transaction, NASD Conduct Rule 2310 requires that a registered representative have reasonable grounds for believing, on the basis of information furnished by the customer, and after reasonable inquiry concerning the customer's investment objectives, financial situation, and needs, that the recommended transaction is not unsuitable for the customer. A broker's recommendations must be consistent with his customer's best interests, and he or she must abstain from making recommendations that are inconsistent with the customer's financial situation."); *In the Matters of Powell & McGowan, Inc.*, Exchange Act Release No. 7302 (Apr. 24, 1964) (a broker has "an obligation not to recommend a course of action clearly contrary to the best interests of the customer"); *see also* FINRA Regulatory Notice 12-25 ("Additional Guidance on FINRA's New Suitability Rule").

7 *See Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969). *See also* SEC Division of Trading and Markets, "Guide to Broker-Dealer Registration" (April 2008).

8 FINRA members' general suitability obligations are set out in FINRA Rule 2111 ("Suitability") and the accompanying Supplementary Materials. *See also* FINRA Regulatory Notice 11-25 ("New Implementation Date for and Additional Guidance on the Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations"), FINRA Regulatory Notice 12-25 ("Additional Guidance on FINRA's New Suitability Rule"), and FINRA Regulatory Notice 12-55 ("Guidance on FINRA's Suitability Rule"). From January 1, 2011 until July 8, 2012 during the review period, FINRA suitability obligations were set out in NASD Rule 2310 ("Recommendations to Customers (Suitability)") and NASD Interpretive Materials, specifically IM 2310-1 ("Possible Application of SEC Rules 15g-1 through 15g-9"), IM 2310-2 ("Fair Dealing with Customers"), and IM 2310-3 ("Suitability Obligations to Institutional Customers"), as applicable. Broker-dealers have additional specific suitability guidance with respect to certain types of products or transactions. *See, e.g.*, NASD Notice to Members 05-59 ("NASD Provides Guidance Concerning the Sale of Structured Products") and FINRA Regulatory Notice 12-03 ("Heightened Supervision of Complex Products").

9 FINRA Regulatory Notice 12-03 ("Heightened Supervision of Complex Products") (citing Rule 2360(b)(19)(B)).

10 *See* Exchange Act Section 15(b)(4)(E), NASD Rule 3010 ("Supervision"), and NASD Rule 3012 ("Supervisory Control System"). On December 1, 2014, FINRA's new consolidated rules governing supervision went into effect. The new Rules 3110 ("Supervision"), 3120 ("Supervisory Control System"), 3150 ("Holding of Customer Mail"), and 3170 ("Tape Recording of Registered Persons by Certain Firms") replace NASD Rules 3010 ("Supervision"), 3012 ("Supervisory Control System"), 3110(i) ("Holding of Customer Mail"), and 3010(b)(2) (often referred to as the "Taping Rule") and other corresponding NYSE rule provisions. *See* FINRA Regulatory Notice 14-10 ("SEC Approves New Supervision Rules").

suitability determination; customer-specific suitability analysis; and training for registered representatives regarding the characteristics, risks, and rewards of SSPs.[11]

III. Examination Observations

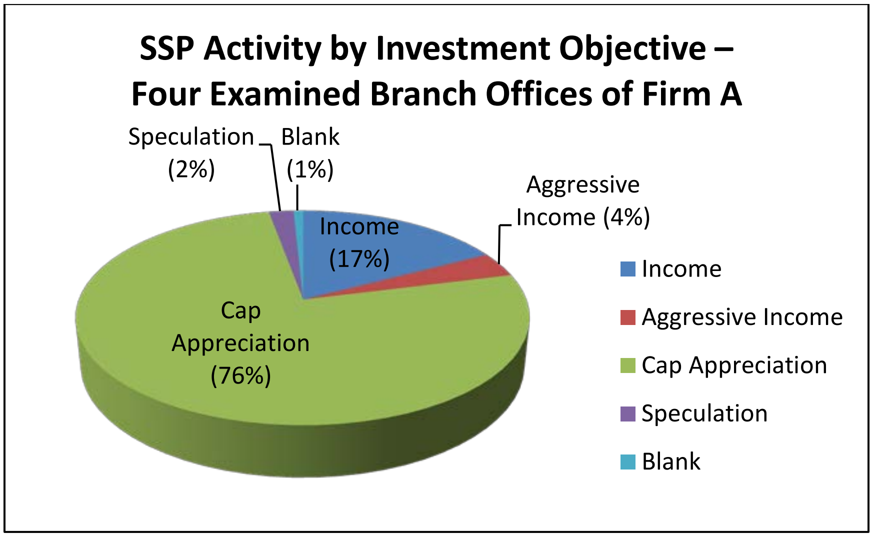
A. Controls over Suitability Determinations

The Staff cited all of the examined firms for deficiencies in failing to maintain and enforce policies and procedures relating to determining the suitability of recommendations of SSPs. All of the examined firms had policies and procedures governing suitability, processes for product development and approval, and training of representatives. Leaving aside the question of the adequacy of the written policies and procedures, the Staff found instances in which such controls were inadequately or inconsistently implemented.

The Staff began its analysis by using data analytics to conduct a review of all SSP sales at the examined firms during the review period. This analysis identified, on an aggregate basis, the predominant types of customers that had purchased SSPs at each firm and branch office, and it allowed the Staff to further scrutinize branch offices and representatives that had made high numbers of sales that merited further review. For example, the Staff's review of all SSP trading at four branch offices of one firm[12] revealed that the firm sold more SSPs to customers in its most conservative investment objective ("Income") than it did to customers in its most aggressive investment objective ("Speculation"): approximately $96 million versus $11 million. While such observations did not necessarily indicate that there were unsuitable transactions, the Staff used this high-level information to identify and request further information from those branches and representatives that had conducted the highest numbers of such sales.

[11] *See* FINRA Regulatory Notice 12-03 ("Heightened Supervision of Complex Products") and NASD Notice to Members 05-59 ("NASD Provides Guidance Concerning the Sale of Structured Products"), supra note 8.

[12] The Staff observed that the SSPs most frequently sold were higher yield, short-term SSPs with maturities ranging from three months to two years. These SSPs provided investors with an opportunity to receive contingent periodic payments of stated amounts of principal or interest if certain criteria were met. Upon maturity, investors would receive either cash in the original amount of the investment or a predetermined number of shares in an underlying company. Depending on market conditions, investors may receive no contingent periodic payments of principal or interest and may not recover the principal amount of their investment at maturity (*e.g.*, receiving shares of an underlying company with a value below that of their original investment). In addition, neither the issuer nor distributor was obligated to repurchase these securities. Further, these SSPs generally were not listed on an exchange. As a result, these SSPs were often illiquid securities.



In this deeper review, the Staff reviewed e-mails indicating that representatives within one branch in particular were aggressively recommending SSPs to customers while appearing to mischaracterize the underlying attributes of the products in light of the goals of the investors, particularly to non-English speaking investors.

The Staff's analysis also revealed that at two of the examined firms there was significant SSP activity in the accounts of elderly customers and in the accounts of customers for whom the firm did not have any age information. Data from one of these firms revealed that the firm often did not collect, and therefore representatives could not consider, information about customers' age when making suitability determinations. While the absence of certain customer specific factors, such as age, does not necessarily render a transaction unsuitable, together with other factors, such lack of consideration may warrant further inquiry.[13] The Staff discovered such additional factors when it also reviewed further documentation at these firms and reviewed e-mails. The documentation and emails indicated that representatives at one firm had retroactively changed customers' investment objectives in their account documentation, without the customers' approval, in order to justify concentrated positions of SSPs in the portfolios.

For each firm, the Staff also reviewed the volume and prices of repurchases of SSPs, often by broker-dealers affiliated with the issuer. While observations related to such reviews did not necessarily indicate that there were unsuitable transactions based on either the original recommendation for the customer to purchase or the subsequent recommendation for the customer to sell, the Staff used this high-level information to identify and request further information from those branch offices and representatives that had conducted liquidation transactions at well below face value (*i.e.*, initial issuance price) of the SSPs. The Staff's review of trade blotters indicated that various account types – including, but not limited to, trusts, individuals, and at least one employee benefits plan – had a large number of SSP purchases

13 *See* FINRA Regulatory Notice 12-25 at Q.17 (providing that the suitability rule "would not prohibit a broker-dealer from making a recommendation in the absence of certain customer-specific factors as long as the firm has enough information about the customer to have a reasonable basis to believe the recommendation is suitable. The significance of specific types of customer information will depend on the facts and circumstances of the particular case.").

during the two-year review period (from January 2011 through December 2012), and many of these SSPs were thereafter liquidated at well below face value of the SSP. Focusing on reverse convertible notes, the Staff found that the branch offices examined liquidated almost 25% of the purchases that representatives had sold to their customers. Over 35% of these liquidations were at prices below 80% of face value of the note, as shown in the table below.

RCN Liquidation Prices[14]	**# of Liquidations**
Less Than 70	27
Between 70 and 80	45
Between 80 and 100	57
Greater than 100	72
Total Sales	**201**
% of Sales Below 80	35.8%

B. Supervision of Suitability Controls

The examinations revealed that all of the examined firms failed to enforce their written supervisory procedures relating to reviews of representatives' determinations of suitability with regard to SSPs. Additionally, the implementation of the firms' review procedures varied across branches of the same firm.

For example, one firm's written supervisory procedures stated that all SSP holdings should not exceed a certain percentage of the client's stated liquid net worth. The Staff's analysis, however, uncovered that, at one branch, more than 1,800 of the over 3,000 SSP transactions (approximately 60%) exceeded the firm's concentration guidelines. In almost 10% of these transactions, the SSPs exceeded twice the total liquid net worth guideline (with some as high as 100% of liquid net worth). This rate was significantly higher than the firm's other branch offices, where less than 15% of SSP transactions exceeded the concentration guidelines.

Moreover, this firm had a system in place to alert representatives and supervisors of breaches of concentration guidelines. This system required, in part, a review and documentation of reasons for an override of the firm's guidelines. At this particular branch, all of these transactions had been approved by the branch manager or complex risk officer with little or no documented explanation to support their approvals. For example, the branch manager and complex risk officer would use generic language that the transactions were approved by the branch, but the language was not specific to either the investor or the transaction and did not explain the basis for the override, contrary to the firm's internal guidelines and observed practices at other branches. In contrast, branch managers and complex risk officers in the firm's other branches who had approved overrides to transactions that breached the concentration guidelines typically documented lengthy and specific descriptions of their reviews and the reasons for the overrides.

[14] For this table of liquidation prices, the face value of the note was 100.

IV. Conclusion

In these examinations, the Staff observed not only indications that the examined firms' suitability controls may be weak, but also significant weaknesses in supervision and implementation of internal suitability and supervisory procedures across branches of the same firm. This Risk Alert is intended to raise awareness of these types of weaknesses in order for registrants to consider them in their own compliance programs.

The Staff welcomes comments and suggestions about how the Commission's examination program can better fulfill its mission to promote compliance, prevent fraud, monitor risk, and inform SEC policy. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify us at http://www.sec.gov/complaint/info_tipscomplaint.shtml.

This Risk Alert is intended to highlight for firms risks and issues that the Staff has identified. In addition, this Risk Alert describes factors that firms may consider to (i) assess their supervisory, compliance and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. These factors are not exhaustive, nor will they constitute a safe harbor. Other factors besides those described in this Risk Alert may be appropriate to consider, and some of the factors may not be applicable to a particular firm's business. While some of the factors discussed in this Risk Alert reflect existing regulatory requirements, they are not intended to alter such requirements. Moreover, future changes in laws or regulations may supersede some of the factors or issues raised here. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.
