



The Commonwealth of Massachusetts
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Securities Division

**GUIDANCE IN CONNECTION WITH THE RETAIL SALES OF STRUCTURED PRODUCTS BY
MASSACHUSETTS REGISTRANTS**

Introduction

In view of the increased sales of structured products to retail investors, the Massachusetts Securities Division (“Division”) publishes this guidance to ensure that Massachusetts-licensed registrants adhere to the requirements of the Massachusetts Uniform Securities Act, G.L. c. 110A (the “Act”), and other applicable securities laws.

While there is no single, standardized definition of structured products, the Financial Industry Regulatory Authority (“FINRA”)¹ recently described structured products as, “securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency.”² In that same Notice to Members, FINRA further noted that broker-dealers were increasingly targeting retail investors with offers and sales of structured products.³ More recently, the Structured Products Association (“SPA”)⁴ reported U.S. sales of structured products for 2006 to be \$64 billion.⁵

Given the increase in sales of structured products, particularly with respect to retail investors, the Division conducted an inquiry into the sales practices and supervision of such products by several Massachusetts-registered firms. The results of that inquiry revealed a variety of concerns in connection with the offer and sale of structured products. One such concern was the improper or inconsistent categorization by broker-dealers of customer complaints made with respect to structured product transactions. Moreover, at least one broker-dealer failed to have structured product-specific policies

¹ The Financial Industry Regulatory Authority was created in July 2007 through the consolidation of the National Association of Securities Dealers (“NASD”), and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange. As used herein, FINRA is synonymous to the NASD.

² *Structured Products*, NASD Notice to Members 05-59 (September 2005).

³ *Id.*

⁴ The Structured Products Association is a trade group representing manufacturers and underwriters of structured products.

⁵ See <http://www.structuredproducts.org>.

and procedures, or any discernable training program for either supervisory staff or registered representatives. In addition to the above, the Division noted a large number of transactions to elderly customers in Massachusetts.

Based on recent analysis, the Division is concerned about the lack of complete, fair, and balanced disclosures, particularly with respect to the risk/reward profile for certain structured products. For instance, the Division is concerned that registered firms and their agents may not completely understand the principal guarantee feature of certain structured products, thus leading to potentially ambiguous or confusing disclosures.⁶ In addition, given the complexity of many structured products, the Division is concerned that customers do not understand that caps are often placed on the upside potential of certain structured products.⁷

As a result of the concerns identified above, the Division publishes the following guidance to assist Massachusetts-licensed registrants adhere to all applicable securities laws when engaging in structured product transactions. This guidance is intended to improve compliance with the requirements of the Act, thereby increasing the protection of Massachusetts investors. The guidance set forth below is not an exhaustive list of procedures that firms should maintain; rather, this guidance supplements all other applicable state and federal securities law requirements.

Structured Products Guidance

In light of these areas of concern, the Division publishes the guidance below. Failure to adhere to this guidance may be deemed:

- Unethical or dishonest conduct in violation of § 204(a)(2)(G) of the Act and 950 CMR § 12.204;
- Supervisory deficiencies in violation of § 204(a)(2)(J) of the Act and 950 CMR § 12.203(3);
- Record-keeping failures in violation of applicable books and records requirements at § 203 of the Act and 950 CMR § 12.203(2); and
- Violations of other applicable securities law requirements, including, but not limited to the anti-fraud provisions at §§ 101 and 102 of the Act.

Retail Sales of Structured Products

Fair and balanced disclosures, as well as customer-specific suitability requirements, are two primary concerns with respect to the retail sales of structured products in

⁶ Craig McCann and Dengpan Luo, *Are Structured Products Suitable for Retail Investors?* (Dec. 15, 2006), <<http://www.slcg.com/pdf/workingpapers/StructuredProducts.pdf>> (“The issue price [for certain equity linked notes] is only 70% or 80% or less of what the US Treasury guarantees it will return on purely risk free securities held for 5 to 10 years and so this return of principal guarantee should not be oversold”).

⁷ See note 2, *supra* (“Structured products also frequently cap or limit the upside participation in the reference asset, particularly if some principal protection is offered...”); & note 6, *supra* (“...capping and not compounding the quarterly returns severely limits the upside potential from stock market gains [in the JP Morgan Capped Quarterly Observation Note]”).

Massachusetts. Registrants must ensure that disclosures are forthright, clear, and complete. Moreover, disclosures must be balanced as to the risks and rewards of structured products transactions. Such fair and balanced disclosure is all the more important given the complexity and opacity of many structured products.

Unbalanced or misleading disclosures made in either oral or written form may constitute unethical or dishonest conduct or practices in violation of § 204(a)(2)(G) of the Act, and is specifically prohibited under 950 CMR § 12.204.

Massachusetts firms must ensure that structured products are sold only in those accounts and to those customers for which those sales are appropriate under the circumstances. In particular, 950 CMR § 12.204 sets forth a non-exhaustive list of unethical and dishonest conduct, which includes, “[r]ecommending to a customer the purchase, sale or exchange of any security without reasonable grounds to believe that such transaction or recommendation is suitable for the customer based upon reasonable inquiry concerning the customer’s investment objectives, financial situation and needs, and any other relevant information known by the broker-dealer.”

With respect to the customer-specific suitability requirement at 950 CMR § 12.204, firms and their agents must also consider the appropriateness of alternative investment options, including the possibility of investing directly in the underlying components of structured products to avoid both the complexity and fees embedded in such products. As more Massachusetts-licensed registrants sell structured products to retail investors, strict adherence to the Act’s disclosure and customer-specific suitability obligations becomes of paramount importance.

Written Procedures & Supervisory System

Broker-dealer firms are often the first line of defense for the protection of investors. Firms meet their supervisory obligations under the Act only by maintaining clearly articulated policies and procedures that are vigorously enforced with adequate resources.

Registrants must maintain detailed, written supervisory procedures specific to the offers and sales of structured products. Furthermore, firms must have a procedure by which structured products are reviewed and approved by the firm. FINRA has repeatedly articulated a broker-dealer’s obligation to conduct a firm-level, reasonable-basis suitability analysis. FINRA’s prior guidance on structured product supervision makes clear that firms must “perform a reasonable basis suitability determination before recommending a product to investors.”⁸ Notice to Members 05-59 further clarified that, “a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards.”⁹ As such, it is simply not enough for a firm to rely on its agents to conduct a reasonable-basis suitability analysis – the firm must conduct such an analysis *prior* to any customer solicitations.

⁸ See note 2, *supra*.

⁹ *Id.*

In addition to maintaining a supervisory system governing all aspects of structured product transactions, firms must also continuously test and assess their supervisory controls, as mandated by 950 CMR § 12.204(1)(a)(28) and FINRA rules.¹⁰ It is crucial that Massachusetts-licensed registrants not only design and develop appropriate written policies and procedures governing structured products, but also vigorously enforce compliance with those procedures. The first step in complying with this requirement is maintaining such procedures, which must include appropriate vetting by the firm of all such structured products.

Maintenance of Records

The securities laws, including § 203 of the Act and 950 CMR § 12.203(2), require the creation and maintenance of specified books and records. Whether referencing sales blotters, marketing materials, or exception reports, such record-keeping requirements are designed to serve a variety of purposes, which include enabling firms and securities regulators to monitor compliance with applicable securities laws. When a firm fails to meet its record-keeping obligations, this inhibits monitoring and other appropriate oversight with respect to transactions in structured products.

Product-Specific Training

Registered representatives must understand the products they offer and sell to investors. Moreover, registered firms are obliged to properly train their selling agents. As such, it is incumbent upon firms to provide representatives with product-specific training to ensure that they are familiar with the characteristics and risks of structured products. In addition, training programs must fully address the entire range of agents' obligations under the firm's procedures, and under state and federal securities laws.

At a minimum, the training must include the features of structured products, including the unique risks posed by such products. Emphasis must be given to fair and balanced disclosures, as well as customer-specific suitability. Training should also be focused on the consideration of appropriate alternatives to investing in structured products, including the possibility of investing directly in the assets underlying such products.

One-time training is not enough. Therefore, firms should design and develop continuing education programs for structured products, with particular focus on the unique risks they pose to retail investors. Firms must also ensure that all supervisory and compliance personnel, including branch office managers, are properly trained in all aspects of structured products.

¹⁰ 950 CMR § 12.204(1)(a)(28) incorporates FINRA Rule 3012, which requires members to test and verify that supervisory procedures are reasonably designed to ensure compliance with all applicable securities laws, rules, and regulations.