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January 4, 2010

Be prepared to justify why some customers bought PPNs, FINRA warns

In November 2008, an official in the **SEC's** Office of Compliance Inspections and Examinations revealed to a *BD Week* audio conference that regulators would be scrutinizing the sale of products marketed as "safe," such as principal-protected notes (*BD Week*, Nov. 10, 2008). The regulators haven't forgotten. **FINRA** recently warned that communications to the public about principal-protected notes better be balanced, and the recommendations must be suitable.

Also, if you allowed PPNs to be bought by customers whose accounts aren't approved for trading options, be ready to show regulators why you permitted those transactions, the self-regulatory organization warns (Regulatory Notice 09-73).

In the audio conference, **Rich Hannibal**, assistant director in the broker-dealer exam program of OCIE, told listeners that because of the bad economic environment, many customers might want products marketed as relatively safe, such as PPNs. And he said regulators would be on the lookout to see if firms are disclosing things like the liquidity and investment risk of the product. Now, a little more than a year later, FINRA is driving home that point. It says you should consider allowing only those investors whose accounts are approved to trade in options to buy certain PPNs that guarantee only a limited return of principal.

In FINRA's view, options are similar to the derivative components of some PPNs.

FINRA emphasized that PPNs frequently are portrayed by firms as safe. PPNs sold to retail investors have names that include terms such as "principal protection" and "capital guarantee," but actually, "Some PPNs have complicated pay-out structures that can make it hard for registered representatives and their customers to accurately assess their risk and potential for growth," FINRA states.

Promotional materials for PPNs should be balanced, FINRA says, and make sure your disclosures include:

✔ The level of principal protection offered;

✔ The credit-worthiness of the guarantor;

✔ The potential returns and pay-out structure (including limits on upside potential);

✔ The customers' ability to get access to the funds before the maturity date or the expiration of the lock-up period; and

✔ Costs and fees that could affect the return of the principal.

In addition to looking at whether an investor's account is approved for options trading, other important factors to examine when determining suitability are credit worthiness of the guarantor and tax consequences, FINRA states.

It also emphasized the need to train reps about the products before letting reps recommend the products to customers.

David Thetford, securities compliance principal analyst with **Wolters Kluwer Financial Services**, suggests that supervisors perform suitability review after the sale of these products - if those firms don't require pre-approval supervisory review.

"I would just do it for however long it took for me to get a warm and fuzzy feeling that my brokers knew what they were doing," he says, noting the complexity of the products. ■