

## Principal-Protected Notes

### FINRA Reminds Firms of Their Sales Practice Obligations Relating to Principal-Protected Notes

#### Executive Summary

The retail market for principal-protected notes (PPNs) has grown in recent years, in part because they are often marketed as combining the relative safety of bonds with a potential for growth not available with traditional fixed income products.<sup>1</sup> However, these products are not risk-free, and their terms and structures can be complex. Firms must ensure that their promotional materials or communications to the public regarding these products are fair and balanced, and do not overstate either the level of protection offered or an investment's potential returns. Firms also have a duty to ensure that their registered representatives understand the risks, terms and costs associated with these products, and that they perform an adequate suitability analysis before recommending them to a customer.

Questions concerning this *Notice* should be directed to the Office of Emerging Regulatory Issues at (202) 728-8472.

#### Background and Discussion

PPNs typically combine a zero-coupon bond with an option or other derivative product whose payoff is linked to an underlying asset, such as an equities index or basket of indices. The investor is guaranteed the return of some or all principal at a set maturity date—typically ranging up to ten years from issuance—and also is entitled to participate in a return that is linked to a specified change in the value of the underlying asset.

PPNs sold to retail investors often have reassuring names that include some variant of “principal protection,” “capital guarantee,” “absolute return,” “minimum return” or similar terms. However, they are not without risk. Most importantly, the principal guarantee is subject to the credit-worthiness of the guarantor. In addition, principal protection levels can vary. While some products guarantee 100 percent return of principal,

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#### Notice Type

- Guidance

#### Suggested Routing

- Advertising
- Compliance
- Legal
- Senior Management

#### Key Topics

- Communications With the Public
- Principal-Protected Notes
- Structured Products
- Suitability
- Training

#### Referenced Rules & Notices

- NASD Rule 2210
- NASD Rule 2310
- NTM 05-26
- NTM 05-59

others guarantee as little as 10 percent. In most cases, the principal guarantee only applies to notes that are held to maturity. Issuers may (but are not obligated to) provide a secondary market for certain notes but, depending on demand, the notes may trade at significant discounts to their purchase price and might not return all of the guaranteed amount.

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. For example,<sup>2</sup> a PPN that guarantees a 10 percent return of principal might be structured so that, if at any time up to and including the maturity date, the underlying index gains by more than 40 percent, the payout at maturity would be as follows:

If the underlying index's return is	... then the note's return is	... so the note investor gets	Examples
A gain of more than 40%	10%	110% of principal returned	Index rises to 160% of its initial level prior to the maturity date and ultimately finishes at 160% of its initial level; note returns 110% of principal. Index rises to 150% of its initial level prior to the maturity date but ultimately finishes at 80% of its initial level; note returns 110% of principal.

However, if the underlying index does not gain by more than 40 percent at any time during the life of the note, then the payout would be as follows:

If the underlying index's return is	... then the note's return is	... so the note investor gets	Examples
A loss of more than 10%	The underlying index return + 10%	From 10% up to (but not including) 100% of principal returned	Index loses 100% as of the maturity date; note loses 90% (i.e., returns 10% of principal). Index loses 50% as of the maturity date; note loses 40% (i.e., returns 60% of principal).
A loss of up to 10%	0%	100% of principal returned	Index loses 2% as of the maturity date; note returns 100% of principal. Index loses 10% as of the maturity date; note returns 100% of principal.
0%	0%	100% of principal returned	
A gain of up to 40%	The underlying index return	More than 100% up to (and including) 140% of principal returned	Index rises 35% as of the maturity date; note gains 35% (i.e., returns 135% of principal).

In another example, a PPN that offers 100 percent principal protection and is linked to the spread between the 30-year and two-year constant maturity swap rates (capturing any widening of the yield curve between long-term rates and short-term rates) might be structured so that in the first year, the note pays the investor a fixed coupon of 10 percent, regardless of the spread:

If the spread between the 30-year and two-year constant maturity swap rates is	... then the note's return is	... so the note investor gets	Example
Any	10% for that year	10% after one year, paid as a coupon	Regardless of the spread, the note investor receives a coupon of 10% at the end of the first year.

However, after the first year:

If the spread between the 30-year and two-year constant maturity swap rates is	... then the note's return is	... so the note investor gets	Examples
Always less than 70 basis points during the year	0% for that year	No coupon payment for that year	Spread fluctuates but is always less than 40 basis points during the year; no coupon is paid.
Greater than 70 basis points on N% of the days in the year (on at least one day but not all days during the year)	10% multiplied by N% for that year	More than 0% but less than 10% for that year, paid as a coupon	Spread exceeds 70 basis points on half of the days during the year; 5% coupon is paid.
Always greater than 70 basis points during the year	10% for that year	10% for that year, paid as a coupon	Spread fluctuates but always exceeds 80 basis points during the year; 10% coupon is paid.

PPNs are also linked to a wide variety of assets or benchmarks, including foreign equity indices, currencies, foreign exchange rates, commodities, spreads between interest rates and “hybrid” baskets of various asset types. For example, a note might be based on the performance of an equally weighted basket comprised of the Russell 2000, Dow Jones U.S. Real Estate Index Exchange Traded Fund, the Brazilian Real-U.S. Dollar exchange rate and the price of copper.

## Communications With the Public

Under NASD Rule 2210, all communications with the public, including advertisements and public appearances regarding PPNs, must present a fair and balanced picture regarding both their risks and potential benefits. Rule 2210 also prohibits exaggerated, unwarranted or misleading statements and the omission of any material fact or qualification that would cause a communication to be misleading.

Therefore, in marketing or describing a product as offering principal protection, firms must ensure that their communications accurately and fairly explain how the securities operate. For example, firms must not overstate either the level of protection offered or the investment's potential for growth. Promotional materials must be balanced, with appropriate disclosures concerning, among other things:

- the level of principal protection offered;
- the credit-worthiness of the guarantor;
- the potential returns and pay-out structure (including any limits on upside potential);
- the investor's ability to access funds pending maturity date or the expiration of a lock-up period; and
- any costs or fees that might affect the return of principal.

Moreover, sales materials and oral presentations that omit a description of the derivative component of a product and instead present such products as ordinary debt securities could violate Rule 2210. Firms should also be careful to balance any statements concerning the fact that a structured product has a ticker symbol or has been approved for listing on an exchange with the risks that an active and liquid trading market may not develop. Firms are further reminded that providing risk disclosure in a prospectus supplement does not cure otherwise deficient disclosure in sales material, even if such sales material is accompanied or preceded by the prospectus supplement.

## Suitability

NASD Rule 2310 requires that, before recommending the purchase or sale of a security, firms must have a reasonable basis for determining that the product is suitable for at least some investors. To make this determination, firms must perform adequate due diligence, which includes carefully reviewing and understanding the risks, costs, terms and conditions of the product being offered. Rule 2310 also requires that, before executing a recommended transaction, a firm must make reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives and "such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."

Therefore, before recommending a PPN, firms must review its suitability, both generally and for specific customers. Among other things, firms should consider the credit-worthiness of the guarantor in assessing the suitability of products offering full or partial principal protection. Firms should also fully understand the nature and terms of the principal guarantee, as well as the investment's pay-out structure, costs and fees.

If the investment is designed to be held until maturity or involves significant lock-up periods, firms should consider the likelihood that the customer will need to access their money before the maturity date arrives or the lock-up period expires. Firms should also understand and consider the call risk associated with any callable notes. There also may be tax consequences that can affect whether the notes are suitable for a specific customer. For example, unless a fund invested in zero-coupon bonds is held in a tax-deferred retirement account, investors may have to pay U.S. income tax yearly on the imputed interest from the fund's zero-coupon bond holdings as it accrues. This may be true even if no actual cash distributions are paid into the account from the zero-coupon bonds held in the fund's portfolio.

Depending on their structure and terms, some PPNs can involve high fees and hidden costs. In addition, investors may be sacrificing higher yield to obtain the principal guarantee. It is also important to note that the principal guarantee generally relates to nominal principal and does not offer inflation protection. While investors may be willing to absorb these costs in exchange for the security provided by principal-protected products, firms should nonetheless take them into account when assessing their general and customer-specific suitability.

Given the similarity between options and the derivative components of some PPNs, firms should also consider whether purchases of certain notes that guarantee only a limited return of principal should be restricted to investors whose accounts have been approved for options trading, and whether it would be appropriate to apply the suitability requirements for options trading to those products.<sup>3</sup> Firms that do not limit purchases of structured products in which investors' principal is at risk from market movements in the reference security to accounts approved for options trading should develop other comparable procedures designed to ensure that structured products are only sold to persons for whom the risk of such products is appropriate. These firms should be prepared to demonstrate the basis for allowing investors with accounts not approved for trading options to purchase structured products.

In addition, NASD IM-2310-2(e) (Fair Dealing with Customers with Regard to Derivative Products or New Financial Products) emphasizes firms' obligations to deal fairly with customers when making recommendations or accepting orders for new financial products. The IM states that "[a]s new products are introduced from time to time, it is important that members make every effort to familiarize themselves with each customer's financial situation, trading experience, and ability to meet the risks involved with such products and to make every effort to make customers aware of the pertinent information regarding the products."

## Training

Firms must train registered persons about the characteristics, risks and rewards of each product before they allow registered persons to recommend that product to investors. Likewise, firms should train registered persons about the factors that would make such products either suitable or unsuitable for certain investors. In the case of PPNs, that training should emphasize the need to understand and consider:

- ▶ the risks associated with such products, including the credit-worthiness of the guarantor;
- ▶ the terms and conditions, including the pay-out structure;
- ▶ the underlying index, asset or benchmark;
- ▶ the investment's potential for growth;
- ▶ the fee structure; and
- ▶ any other features that might impact the product's suitability, both generally and for a specific customer.

## Endnotes

- 1 As used in this *Notice*, the terms "principal-protected note" and "PPN" refer to any structured product that combines a bond with a derivative component and that guarantees a full or partial return of principal at maturity.
- 2 The examples in this *Notice* are hypothetical composites based on terms and structures of real notes, and are included for illustrative purposes only.
- 3 See *Notice to Members (NTM) 05-59*. Also see *NTM 05-26* regarding vetting new products.