

Commentary: Investors' Reversal of Fortune With Reverse Convertibles

By Scott M. Dubowsky; The Nelson Law Firm, LLC

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Reverse exchangeable notes, or “reverse convertibles,” were popular investments prior to the recent market collapse. Investors bought nearly \$7 billion of these securities in 2008. But when the equity markets crashed, so did the value of many reverse convertibles. Some investors were shocked to learn that the investments sold to them as safe alternatives to bank certificates of deposit or Treasury securities actually were highly complex structured products with significant amounts of downside risk. As we now know, many brokers pitched reverse convertibles as ordinary high yield bonds and neglected to disclose the risk of loss inherent in their exchange feature. These questionable sales practices, and a slew of investor complaints, have gotten the attention of both the plaintiffs’ bar and FINRA. FINRA has made reverse convertibles a priority for its enforcement division. Earlier this year, FINRA also issued an investor alert and a notice to members targeting the sale of reverse convertibles.

Reverse convertibles are a structured product comprised of an unsecured note and a put option. The put option generally gives the issuer the right to repay the principal of the note with a fixed amount of some asset (often an individual common stock) in lieu of cash, if the value of the identified asset falls below a specified price, or “knock-in” level. The knock-in level usually is set approximately 20% to 30% below the underlying asset’s price at the time the reverse convertible is issued. Part of the above-market yield on reverse convertibles reflects the risk of loss of principal associated with the exchange feature. The holder of a reverse convertible does not own the asset tied to the note and is not entitled to participate in any appreciation in the value of that asset. The holder is betting that the value of the underlying asset will remain above the knock-in level, while the issuer is betting that the price will fall. If the value of the underlying asset drops below the knock-in level, the issuer can relieve itself of the full principal obligation by delivering the lower-value underlying asset, while the note-holder ends up bearing the loss.

Reverse convertibles continue to be a very popular investment among individual investors. FINRA reports that, despite a history of abusive sales practices and a somewhat dismal performance record, reverse convertibles are once again among the most popular structured products with retail investors. Bloomberg has reported that investors purchased nearly \$700 million of reverse convertibles in May of this

year. At that pace, sales of reverse convertibles in 2010 will outpace the staggering 2008 figure.

It is not hard to understand why reverse convertibles are such a tempting investment for individual investors. First, they offer shockingly high yields. Some reverse convertibles have been known to have yields as high as thirty percent. Moreover, some brokers continue to market reverse convertibles as relatively safe, short-term fixed income securities. These brokers downplay the risks of reverse convertibles, and fail to explain their complexities. Reverse convertibles often have complex fees and pay-out structures that can make it very difficult to accurately assess their risks, costs, and value. According to FINRA, it is *“all but impossible”* for individual investors to determine whether reverse convertibles represent a good deal.

These securities have a checkered past and a worse looking future. A 2009 Wall Street Journal article referred to reverse convertibles as *“nest-egg slashers”* and *“the investment that just won’t die.”* More recently, an August 2010 Bloomberg article called reverse convertibles *“Wall Street’s next bubble”* and went on to note that there are hedge funds that *“are being established specifically to buy this crap from distressed retail investors as and when rates start to rise.”* In February, FINRA fined H&R Block Financial Advisors Inc. \$200,000 for failing to establish supervisory systems and procedures in connection with the sale of reverse convertibles, and it is doubtful that this will be FINRA’s last enforcement action in the area.

Further to the H&R Block enforcement action, earlier this year FINRA issued an investor alert and a regulatory notice to members concerning sales practices for reverse convertibles. The message from FINRA was quite clear: reverse convertibles are not suitable for most individual investors, and brokers should only offer these investments to a very select group of investors who are given full and fair disclosure.

FINRA’s notice to members imposed no new requirements; rather, it was a stern reminder of members’ existing obligations. Some of the highlights of FINRA’s notice are set forth below.

Communications With the Public and Other Sales Practices

FINRA cautioned firms to take steps to ensure that customers make an informed decision about whether to purchase reverse convertibles. FINRA suggested several topics to be discussed with customers, including how the product works, that the principal amount of the investment is not guaranteed, and that the ability of an investor to sell the product may depend on the existence of secondary market. FINRA reminded firms of their obligations under NASD Rule 2210, including the obligation to ensure that all communications with the public are based on the

principles of fair dealing and good faith. FINRA specifically pointed out that firms should never suggest that reverse convertibles are ordinary debt securities or exaggerate the probability that the investor will receive a full return of principal.

Suitability

FINRA noted that 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 generally, and for each specific customer to whom it is recommended. Because each reverse convertible is unique, firms must perform this analysis separately for each reverse convertible they recommend.

Eligible Accounts

Because reverse convertibles have an option component, FINRA cautioned firms to consider whether purchases of reverse convertibles should be restricted solely to investors whose accounts have been approved for options trading.

Supervision and Training

FINRA reminded firms that they must have adequate written supervisory procedures and supervisory controls and must adequately train employees who sell, and who supervise those who sell, reverse convertibles. Among other things, training should emphasize the need to understand and consider the costs and risks associated with the product, the terms and conditions of the product, the reference stock, index or other asset underlying the product and any other features that might impact the product's suitability, both generally and for a specific customer.

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Reverse convertibles are wolves in sheep's clothing. They are complex instruments that look like ordinary bonds and have been sold as higher-yielding alternatives to ordinary bonds. Most investors should follow FINRA's advice and steer clear. And for the brokers who continue to sell these instruments to elderly investors as if they were fixed income securities suitable for a retirement portfolio: prepare to answer some questions from FINRA and from plaintiffs' lawyers.

Scott M. Dubowsky is a member of The Nelson Law Firm, LLC in White Plains, N.Y. He can be reached at smdubowsky@nelsonlf.com.