HOW SAFE ARE YOUR SAVINGS?

How Complex Derivative Products Imperil Seniors' Retirement Security

BY JOHN F. WASIK

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EXECUTIVE SUMMARY

For far too long, brokers have been selling their older clients complex investments known as "structured products." Structured products are the black boxes that bedeviled Wall Street in 2007-2008 on a nearly catastrophic level. They continue to be sold in smaller packages to Main Street investors. While some of them may manage risk to some degree, they are difficult to understand and pose myriad risks to unsuspecting investors. These products are so risky, and so costly in fees, that some of them are almost sure money losers. They entered retirement portfolios like Trojan horses, and then destroyed people's life savings. Yet the financial meltdown of 2008 has not chastened Wall Street. Brokers and banks continue to sell these high-risk investments to people who can't afford major losses. Last year, banks and brokers sold more than $52 billion of these products — including at least $32 billion by the top banks alone — mostly because they are hugely profitable to the banks and brokers themselves.

Individual investors have lost at least $113 billion and counting from Wall Street's most toxic retail investments, which go by myriad names such as reverse convertibles and principle-protected notes or enhanced notes. Actual losses could be ten times that, since most burned investors don't confront their brokers or win back their money.

Many individual investors are still struggling to recover catastrophic losses suffered from investing in complex derivative-based vehicles that tanked in 2008. Now, long after the top banks were bailed out and recapitalized by taxpayers and the Federal Reserve, Wall Street continues to sell these dangerous complex products, which lie in wait, ready to unleash a shocking new wave of financial pain.

This latest round of Wall Street chicanery involves opaque derivatives once sold exclusively to sophisticated institutional investors, who only held small portions of them in multi-billion-dollar portfolios. In recent years, these complex "structured" derivative products — wagers based on other financial instruments — have been repackaged by Wall Street as ways to preserve principal for yield-starved Main Street investors.

Few investors fully understand what they've been sold, or understand that these products are like a ticking time bomb. When these products are sold to seniors, as they frequently are, it threatens their retirement security, as the investments are loaded with risky derivatives and contain no viable income guarantees. Even when investors discover that they've lost money, the system is designed to thwart efforts to recover such losses.

This trend was documented by more than a year's worth of research involving interviews with investors, state securities regulators, investors' attorneys and officials with the Securities and Exchange Commission (SEC). This paper examines what these investments are, how they are sold and what Congress and the SEC need to do to protect investors.

Introduction

GREED MEETS UNBRIDLED TRUST. This has been the narrative in thousands of cases where older, income-oriented investors turned their money over carte blanche to brokers, who consistently and methodically abused their client relationships.

Far too often, brokerage houses have left high-commission-generating brokers unsupervised, allowing brokers to peddle investments labeled "safe and secure" that can easily blow up and shatter the retirements of older investors.

Though these products are being sold by nearly every large bank and brokerage house — including such bailout recipients as Goldman Sachs and Bank of America — they are far too complicated and risky for the average investor.* Most investors who buy these vehicles have no idea how they work or how unsecure they are.[1]

AS WAGES HAVE STAGNATED and pensions have evaporated, investors feel less secure, vulnerable to the impact of undersaving, unemployment or market downturns. Portfolios are not only falling short in terms of retirement goals, they are not keeping up with the cost of living. And when investors feel financially insecure, they are more likely to buy higher-yield vehicles in an attempt to make up shortfalls. Because their confidence and retirement kitties are bruised, they take more risk in hopes of gaining higher returns.

Historically low yields on savings vehicles like certificates of deposit have further eased the way for the sale of structured products.[2]

Millions are vulnerable to the suggestion that they can quickly close the gap in their retirement savings. According to the 2011 Retirement Confidence Survey, from the Employee Benefit Research Institute, confidence is at the most pessimistic level ever measured in nearly two decades of conducting the survey.[3]

Most of these products come under the loosely defined title of "complex income-oriented" or "structured notes." They are derivatives (based on the value of a stock, bond or index) combined with an underlying investment such as a bond, stock or index.*

The first wave of structured product losses was triggered by the September 2008 failure of Lehman Brothers, the biggest bankruptcy in US history. Lehman had sold unsecured debt in the form of so-called "principal protected notes" through brokers. When the firm collapsed, all of the notes became worthless. Investors lost billions, and have only begun to see compensation from the brokerage houses that sold them the notes.

STRUCTURED PRODUCT SALES BY TOP SELLERS

(January – November 2010)[4]

PROVIDER	SALES (IN BILLIONS)	MARKET SHARE
Morgan Stanley	$8.38	18%
Bank of America	$7.46	16%
Barclays	$6.32	13%
JPMorgan	$4.21	9%
Goldman Sachs	$3.97	8%

SOURCE: *Structuredretailproducts.com, November 24, 2010.*

* *Note: This report does not refer to any structured vehicles that carry FDIC insurance.*

In April of this year, securities regulator FINRA fined UBS Financial Services $2.5 million and ordered the firm to pay $8.25 million in restitution for misleading investors in the sale of the Lehman notes.[5]

"It's unbelievable," says Margery Bronster, the former attorney general of Hawaii who now represents broker victims. "It's a completely under-reported area. People had no idea what they were purchasing."[6]

Those who are most vulnerable have saved and invested all of their lives. They believed in the good faith of their brokers and the global brand names of their financial-service employers. Through saving and conservative investing, they did well over time. That success, ironically, has made them prime targets for rapacious brokers and agents. Additionally, many are targeted because they are highly trusting, cognitively impaired or at facing severe health issues.[7]

"Brokerage firms target the elderly with high-commission products and intense sales pressure," says Andrew Stoltmann, a Chicago attorney who has represented hundreds of wronged investors. "Unfortunately most investors don't realize their broker is little more than a commissioned salesperson," with no legal requirement to watch out for their clients' best interest. "The result," Stoltmann continues, "is that seniors are taken for billions each year."[8]

Louis Straney, a securities arbitration consultant in Santa Fe, New Mexico, has been involved in Wall Street dealings since the junk-bond days of the 1980s. He frequently serves as an expert witness for investors trying to get their money back from brokers who sold them structured products.

"In my three decades of Wall Street experience, I have not seen any other product as absurdly destructive as retail investments linked to structured products," Straney said. "Deservingly, the architects and marketers of these bizarre investments are facing a long-term battle with investor rage and regulatory scrutiny."[9]

Unlike Ponzi schemes, structured products are sold every day by licensed brokers. Many mutual funds contained them. And individual investors often have them in their portfolios unawares. Yet they are based on the same flawed casino reasoning that tanked global financial markets in 2008.

Ironically, many brokers I interviewed have told me they don't fully understand how they work or what's behind them.[10] Bryan Lantagne, of the Massachusetts Secretary of State's office, which is currently investigating reverse convertible structured notes, echoed that point, noting that a lack of adequate broker training is a major problem. "You can't properly disclose the risk benefits if you don't really understand what you're selling," he said. "More often than not the commission [is all] they understand."[11]

Regulators have been aware of how dauntingly complex and risky they are for more than six years, yet still permit their sale to uninformed investors.[12]

In fact, regulators typically only catch wind of inappropriate sales once people have lost millions. And most who get caught in such toxic investments don't file complaints. They are ashamed that they were burned by a broker they have known for years, someone they considered a friend.

Wall Street has managed to sweep this largely invisible scandal under the rug. These products, unfortunately, were barely addressed by the Dodd-Frank financial reform law and could continue to harm investors for years to come.

FINRA/NASD MEMBER NOTICES TO BROKERS ABOUT STRUCTURED PRODUCTS

NOTICE #	DATE	WARNING
05-59	9/2005	Structured products sales
09-73	12/2009	Principal protected - notes
10-09	2/2010	Reverse convertible sales
10-51	10/2010	Commodity-linked structured products

SOURCE: *www.finra.org*

The Sting: Targeting Seniors

One popular structured product that was pitched directly to income-oriented investors smarting over low savings yields was called, deceptively, a "principal-protected note." Underwritten by Lehman Brothers and sold by most major brokerage firms, the notes appeared to answer the cry of millions of investors living on their interest: How do I get a higher secure yield?

Brokerage houses like UBS Investments, a division of the Swiss Bank, seized upon this concern and sold more than $1 billion of these notes, issued by Lehman.[13]

But when Lehman collapsed under the weight of its own debt and toxic securities in September 2008, Main Street investors were wiped out. Their supposedly low-risk investments turned out to be unsecured Lehman debt. Most had no idea what they owned.

Charles Replogle of Vero Beach, Florida, told that they were safe, bought the 6-percent-yielding Lehman notes from UBS for his mentally disabled brother and his 86-year-old mother. He trusted his broker, a friend whom he had known since he was 9. The Replogles lost every penny of the $130,000 they invested in the notes.[14]

"There was no mention of Lehman Brothers," Replogle said. "I felt UBS deceived us. You can't sell a guaranteed product and not guarantee it."

Similarly, Rob Brunhild of West Bloomfield, Michigan, invested in the Lehman notes through UBS for his family trusts and his 80-year-old mother. He expected, he said, a "good solid return with minimal risk. The broker implied that they were like [U.S.] treasuries." His family lost $275,000 when Lehman tanked.[15]

"I had to tell my mother," Brunhild said. "Mom lived off of this money."

Even relatively sophisticated investors like Tricia Flanagan, 58, a real estate agent in Kiawah Island, South Carolina, who had earlier been burned in the dot-com crash of 2001, got taken in by the UBS/Lehman pitch.[16]

Flanagan had invested $225,000 in the notes, and lost everything — even though she had tried to get out of her investment once it was apparent Lehman was in trouble. She, too, had placed her utmost trust in her broker — and her broker talked her out of selling. In the end, her retirement fund was lost and she had to hire an attorney to file an arbitration claim in an attempt to get her money back. Efforts to contact her former broker were unsuccessful.

"There were people who knew we were sitting ducks. I'm very honest and good at what I do. I was vulnerable, though, and felt I was targeted." – TRICIA FLANAGAN, FORMER LEHMAN INVESTOR

"There were people who knew we were sitting ducks," Flanagan said. "I'm very honest and good at what I do. I was vulnerable, though, and felt I was targeted."

Retired Houston policeman Jerry Jones, 59, lost more than $109,000 in Lehman preferred stock, even though his broker assured him his investment would

be "similar to a CD" in its level of safety.[17]

When contacted, Allison Chin-Leong, a spokesperson for UBS, denied any wrongdoing. "UBS properly sold Lehman structured products to UBS clients, following all regulatory requirements, well-established sales practices and client disclosure guidelines," she said. "Any client losses were the direct result of the unexpected and unprecedented failure of Lehman Brothers, which affected all Lehman bondholders."[18]

Chris Vernon, an attorney based Naples, Florida, represents dozens of older investors, including the Replogles and Brunhilds, in their fight against brokers.

"Clearly Wall Street was — and still is — targeting fixed-income investors," Vernon said. "Most of them are retirees seeking a steady source of income while guarding against any material loss of principal." Vernon's firm has filed more than two dozen claims totaling more than $10 million since 2008, "the vast majority of which" were filed in 2009 or 2010.

He likens brokers targeting older investors for structured and derivative product sales to what Willie Sutton said about why he robbed banks — "Cause that's where the money is."[19]

Vernon is hardly alone. Across the country, claims relating to structured products have surged. When I surveyed attorneys nationwide representing clients who got stung by structured products, most said they are seeing a large wave of claims by income-oriented investors who got saddled with these unsuitable products. Many are just now taking action for losses they sustained in 2008.[20]

Joe Borg, an Alabama state securities director who is probing a number of cases involving income-oriented investments who lost money, said, "There's no doubt that structured products are targeted toward older folks. There's the issue of outliving their money when it is tied up in low-yielding CDs and bonds. They're a scared group."

State regulators interviewed for this report have seen complaints rise in the most populous areas and fear the problem is going to get much worse.[21] On the federal level, FINRA, the Financial Industry Regulatory Authority, has jurisdiction. In most of FINRA's complaint categories in 2009, the year after the crash, the number of problems are double what they were the year before.[22] These numbers largely reflected investors who got scorched in 2008 — and more of these individuals are coming forward every day. Last year, both the SEC and state securities agencies set up special task forces to police structured products.[23] [24]

ARBITRATION CASES FILED BY TYPE

TYPE OF CONTROVERSY*	2007	2008	2009	2010	JAN./FEB. 2011
Margin Calls	45	64	128	83	15
Churning	133	212	306	270	36
Unauthorized trading	174	248	478	397	46
Failure to supervise	830	1,029	2,691	2,372	320
Negligence	891	1,602	3,405	2,698	364
Omission of facts	275	1,201	2,453	1,941	255
Breach of contract	953	1,658	2,802	2,184	300
Breach of fiduciary duty	1,616	2,836	4,206	3,162	446
Unsuitability	695	1,181	2,473	1,974	259
Misrepresentation	739	2,005	3,408	2,601	339
Online trading	1	3	0	0	0

SOURCE: *FINRA.org*

**Each case can be coded to contain multiple controversy types. Therefore the columns in this table cannot be totaled to determine the number of cases served in a year.*

But accountability has been scarce. Under most securities brokerage contracts, investors waive the right to sue and must sign a binding arbitration agreement that forces them to seek redress through an arbitration forum run by the securities industry itself.[25]

As indicated in the table above, the bulk of the investor arbitration complaints registered by FINRA involved negligence, breach of fiduciary duty, breach of contract or misrepresentation. Translation: Investors were duped into buying inappropriate investments. While FINRA does not disclose which type of these vehicles the complaints were based on, at least some of these abuses involved structured products and other risky securities. The table also shows that after 2007, the abuses surged.

Toxic Products

BEFORE THE MELTDOWN

Many of the worst complex derivative and structured products were sold before the market meltdown of 2008. Investors are still trying to recover billions — at least $113 billion, by our estimate — through class-action lawsuits and broker arbitrations.

AUCTION-RATE SECURITIES

These complex derivative products were pitched as if they were safe money market funds (which are required by law to invest only in low-risk securities).[26] Yet when the $330 billion ARS market failed and banks froze them in 2008, investors were stuck. So far, multiple settlements between regulators and investors have returned more than $90 billion to individual investors through repurchase agreements, although some investor complaints are still pending.

INVESTORS WHO HAVEN'T BEEN MADE WHOLE ARE SITTING ON AN ESTIMATED $100 BILLION IN LOSSES.[27 28]

FANNIE MAE AND FREDDIE MAC PREFERRED STOCKS

These were pitched in late 2007 and early 2008 as the ultimate high-yielding safe bet. Brokers sold these stocks, special issues of the giant mortgage companies, as if they were as sound and secure as Treasury securities. It was known by at least 2006 that both companies had severe accounting irregularities and had purchased large quantities of highly risky subprime mortgages. [29 30 31] But brokers told investors that the government would cover them if the companies got into trouble.[32] The U.S. Treasury ended up taking over both companies in late 2008, but the receivership wiped out the value of the newest preferred stock and most of the common stock. Neither Treasury nor Congress made any effort to make small investors whole.[33 34] Several institutional and small investor class-action suits are pending,[35] but as of this writing, the Obama Administration has yet to decide what to do with the companies.[36] It seems unlikely that preferred stockholders will ever be made whole.

TOTAL INVESTOR LOSSES HAVE NOT YET BEEN ESTIMATED.[37]

LEHMAN BROTHERS PRINCIPAL-PROTECTED NOTES

Brokers sold as safe what were later revealed to be unsecured loans from the New York investment bank. When the firm became the largest US bankruptcy in history in September 2008 the notes became worthless, even though they were promoted as low-risk. The State of New Hampshire is suing one of the largest sellers — UBS Investments — and other states are investigating. On April 11 of this year, FINRA fined UBS Financial Services $2.5 million and ordered the firm to pay $8.25 million in restitution for "omissions…that effectively misled some investors" in the sale of the Lehman notes. (UBS neither admitted nor denied the charges.)[38] Individual investors are still pursuing arbitration claims against brokers who sold the notes. UBS denies any wrongdoing while it was selling the notes.

INVESTORS INITIALLY LOST MORE THAN $8 BILLION.[39 40]

MEDICAL CAPITAL HOLDINGS (MEDCAP)

These high-yield, private-placement securities were sold by brokers as "safe and secure," according to one burned investor who filed an arbitration claim; a way to profit from loans to hospitals in the form of promissory notes.[41] But Medcap investors lost substantial sums of money. The State of Massachusetts has sued the primary broker of these securities, Securities America, for fraud, charging that it failed to reveal risks to investors. Other actions have been taken by FINRA and the SEC, and many individual investors have pursued arbitration claims. In April of this year, Ameriprise Financial agreed to pay $150 million to settle claims against its Securities America broker/dealer unit, involving the sale of notes from Medcap and Provident Royalties. A statement issued by Ameriprise acknowledged that "the frauds allegedly committed by Medical Capital and Provident Royalties have harmed many investors and companies, including Securities America."[42]

INVESTORS HAVE LOST AN ESTIMATED $700 MILLION. [43]

MORGAN-KEEGAN BOND FUNDS

According to FINRA, investors in bond funds issued by this brokerage firm (the parent company was the bank Regions Financial) were told by brokers that these funds were safe, conservative investments, only to experience huge losses due to highly risky investments in mortgage securities that plummeted in value in 2008. The Alabama Securities Commission is suing the company on behalf of investors, who have filed arbitration claims against the company, claiming the risks of these investments weren't fully disclosed. Other states — mostly in the Southeast — are investigating as well.[44] Kathy Ridley, a spokesperson for Morgan-Keegan, denied that the company had any responsibility for the losses. "After years of consistent success, the Funds ultimately suffered unprecedented losses due to the global collapse of the financial markets," she said. "This was a stunning turn of events for all global markets. Morgan Keegan conducted business ethically and responsibly throughout this disastrous period."[45]

INVESTORS LOST AN ESTIMATED $1 BILLION.[46]

CITIGROUP MAT/ASTA FUNDS

These were actually a series of risky municipal arbitrage hedge funds pitched to conservative investors, who were assured by brokers that their money was invested in a safe fixed-income alternative. Some marketing materials even called them "an attractive alternative" to a bond index. Sold by Smith Barney and Citigroup Private Bank between 2002 and 2007, the funds

CITIGROUP MAT/ASTA FUNDS (CONT.)

lost from 70 to 97 percent of their value in early 2008.

In November 2010, SEC officials probed the failure of the funds, investigating claims that in-house brokers at Citi had misled investors about how risky the funds were.[47] In April of this year, two individual investors were awarded $54 million in a securities arbitration claim; Citigroup spokesperson Alexander Samuelson told the *New York Times*, "We are disappointed with the decision, which we believe is not supported by the facts or law."[48]

INITIAL LOSS TO INVESTORS: ALMOST $2 BILLION.[49]

SCHWAB YIELD-PLUS FUND

Like so many income investments, the YieldPlus short-term bond fund was touted by Schwab representatives as equivalent in security to money market funds, according to FINRA. And like the Morgan-Keegan funds, it contained volatile mortgage securities, including uninsured subprime loans, which crashed in late 2008.[50] Schwab spokesperson Sarah Bulgatz denied any wrongdoing. "The decline of the YieldPlus fund was caused by the credit crisis and unprecedented housing market collapse of 2007-2008," she said. "Even in the face of the credit crisis, the average Yield Plus shareholder lost only 7.5 percent of his or her investment."[51] Many investors lost much more than that.

INVESTORS LOST AN ESTIMATED $1.1 BILLION.[52]

PRODUCTS STILL BEING SOLD

These vehicles are still on the market and have been named by SEC, FINRA and state regulators as posing extraordinary risks to investors.

REVERSE CONVERTIBLES

These derivative vehicles, which promise a yield of up to 30 percent, have also been a consistent source of complaints from investors. These bonds are derivatives based on stock prices, so if the underlying stocks plummet in value — and there are thousands of them — investors could lose serious money.[53] [54] Many of the investor complaints regarding reverse convertibles come from the Northeast, and the State of Massachusetts is currently investigating these products. About $18 billion of these products have been sold since 2008.[55]

Although they are slow to react, regulators continue to crack down on brokers who sold these vehicles to retired investors, hinting at the scope of the problem. In February 2010, FINRA fined H&R Block Financial Advisors $200,000 and suspended a broker for the firm for selling reverse convertibles to a retired couple (Block neither admitted nor denied the charges).[56] In October 2010, FINRA fined broker Ferris Baker Watts LLC (of RBC Wealth Management) $500,000 for "inappropriate sales" of these products, and ordered the firm to pay $190,000 to a total of fifty-seven Ferris account holders who were at least 85 years old or had a modest net worth. (With this settlement, too, the firm neither admitted nor denied the charges.)[57] FINRA continues to investigate other marketing abuses and investor losses involving the notes. Total investor losses are unknown, but are sure to skyrocket in the case of another market crash. FINRA issued a warning about these products, calling them "complex investments" that feature "risks that can be difficult for individual investors and investment professionals alike to evaluate." "You could wind up," the warning continues, "with shares of a depreciated — or even worthless — asset."[58]

OTHER STRUCTURED PRODUCTS AND BROKER-SOLD VEHICLES.

FINRA and state regulators are also probing losses from such products as reverse/inverse exchange-traded funds, "Regulation D" private placements, and other "principal-protected" products.[59] [60] FINRA continues to probe cases in which highly risky investments are sold to older investors. The agency is reorganizing its enforcement division and recently appointed a new enforcement chief. And FINRA's chairman, Richard G. Ketchum, has proposed that the agency take over regulation of investment advisors from the SEC.[61]

INAPPROPRIATE INVESTMENTS

Craig McCann, PhD, a securities litigation expert with the Securities Litigation and Consulting Group in Fairfax, Virginia, has written several papers analyzing structured products in depth and is widely considered the leading analyst of these products. In one paper, "Are Structured Products Suitable for Retail Investors," written with Dengpan Luo, PhD, and published in 2006, he dissects whether investors would fare better investing in a structured product or investing directly in stocks or bonds.[62] His conclusion:

> *Structured products can be too complex and opaque for retail investors and registered representatives [brokers] to understand. This complexity and opaqueness allows structured products to survive in the marketplace despite their marked inferiority to traditional portfolios of stocks and bonds.*

Jake Zamansky, who has represented structured product investors in arbitration cases, found that today's income-oriented investors don't fully understand what they are being sold.[63]

"These structured products are opaque and complicated. People don't understand the risks and costs. SPs [structured products] are sold and not bought. Nobody asks for them."

Big Losses Ahead?

The big appeal for structured products is this: they claim to offer "protection" of principal. The trouble is this claim often turns out to be completely false.

Nearly three years after the 2008 meltdown, investors are still trying to recover their losses. As investor claims poured in, arbitration filings against brokers soared in 2009 to more than 7,000, compared to less than 5,000 in the previous year, according to FINRA, the securities industry regulator.[64] The main reasons for those filings, according to a FINRA overview, were "breach of fiduciary duty, misrepresentation, negligence, breach of contract, failure to supervise, and unsuitability."[65]

According to Janet Tavakoli, a consultant on structured finance who has written several books on these products, "These notes flunk the suitability and appropriateness test for retail investors. They also flunk the test for most investment managers, investment advisors and pension fund managers. Retail investors may find that the managers who are supposed to protect their interests are in fact collecting fees and turn a blind eye to the risks."[66] [67]

Only a handful of academics and industry analysts have carefully studied structured products, but many of those who have say that these products are clearly unsuitable for most conservative investors and simply shouldn't be sold to them.

Any yet, like variable annuities — another perennially oversold investment — structured products are sold aggressively.[68]

Christopher Whalen, an industry observer, is managing director of Institutional Risk Analytics in Torrance, California. He predicted the collapse of the mortgage securities market in 2007 and has criticized banks and brokers alike for their poor disclosure in selling structured products. He has also pointed out that many of the products are illiquid, meaning they can't easily be resold since there's little or no market for them and most of them are unlisted securities not traded on exchanges.[69] In a presentation to FINRA regulators in November 2010, he called complex structured notes a "wolf in sheep's clothing."[70]

It's difficult to say who's been burned the worst by the inappropriate selling of these products to retail investors. Tracking of investor complaints is poor. Older investors are less likely to file complaints, investors' attorneys say.[71] When they do, they are forced into the industry's arbitration system, run by brokerage regulator FINRA. As shown in the table at left, FINRA didn't even track structured products or "derivative securities" complaints until 2008.[72] And yet they were

SECURITY TYPES INVOLVED IN ARBITRATION CASES

TYPE OF SECURITY*	2007	2008	2009	2010	JAN./FEB. 2011
Corporate Bonds	71	163	373	239	23
Certificates of Deposit	16	31	71	41	7
Mutual Funds	395	1,069	1,556	863	111
Options	110	149	275	161	37
Common Stock	790	773	1,367	862	139
Limited Partnerships	19	33	73	80	8
Annuities	243	236	300	208	27
Preferred Stock	26	115	481	232	31
Variable Annuities†	—	47	300	279	36
Derivative Securities**	—	801	607	228	11
Auction Rate Securities**	—	299	276	149	16

SOURCE: *FINRA*

** Each case can be coded to contain multiple security types. Therefore the columns in this table cannot be totaled to determine the number of cases served in a year.*

*** Tracking of these statistics began on January 1, 2008.*

one of the top sources of investor complaints that year.

Even bond mutual funds held derivative perils for investors, as several of them, most notably ones sold and managed by the Schwab (YieldPlus) and Morgan-Keegan brokerages, suffered large losses when they invested in mortgage securities in 2008. Both companies pitched their funds as secure income alternatives, according to FINRA, and both attributed all losses in those funds to the housing crisis.

Louis Kelly, 67, a retired mail carrier in Bessemer, Alabama, lost $100,000 in the Morgan-Keegan RMK Select Intermediate bond fund, which lost money in mortgage securities. He received $50,000 in a settlement from the company. He was sold the fund by a broker he knew, whose employer was a bank holding company, Regions Financial.

"I told them [Morgan-Keegan] that I wanted a safe investment and wanted the bulk of principal to remain intact," Kelly said. "I just wanted a steady income. I have a small Air Force and Post Office pension. It didn't cripple me, but I'd like to have it all back." The bank denies any wrongdoing.[73]

Ed and Rod King, two retired brothers from the Tuscaloosa, Alabama, area, lost $420,000 in the Morgan-Keegan bond funds. Ed King said the funds were touted by their broker friend as "safe and secure."[74]

"Most people don't know what they have yet," said Joe Borg, the Alabama state securities director. He is currently suing brokerage firm Morgan-Keegan on behalf of investors over bond fund losses involving mortgage securities. "The big wave is yet to come."[75]

> "These notes flunk the suitability and appropriateness test for retail investors. They also flunk the test for most investment managers, investment advisors and pension fund managers.
>
> — JANET TAVAKOLI, CONSULTANT ON STRUCTURED FINANCE

Broken Accountability

The myriad drawbacks of structured products haven't impeded Wall Street in the least because no regulator has halted their highly profitable sales. With the promise of high commissions and double-digit yields, sales will continue to climb — until the next market downturn. Brokers will likely continue to sell structured products aggressively, because they can reap from 3 to 10 percent commissions selling them, versus a typical 1 to 3 percent for a plain vanilla bond.[76]

Banks are enamored of these vehicles, too, because they can charge more than 1 percent for underwriting fees — 1 percent or less is typical for a plain vanilla bond — a cost that is passed along to investors. In an era in which bond yields have been lackluster and commissions have been driven down by deep-discount brokers, structured products have become a money machine for the largest "wire house" brokerage firms and mega banks.

Many investors first hear of these vehicles in a bank lobby, when inquiring about how to pursue higher yields. With most savers struggling to find a decent yield above 1 percent, reverse convertibles look incredibly appealing.[77] But brokers gloss over the fact that these are inappropriate investments for those who are income-oriented.

"Elderly people have a comfort level with bank introductions to brokers," said Geoff Evers, a Sacramento-based lawyer who has handled reverse convertible cases for investors. "One client was a 90-year-old retired widow who was sold reverse convertibles for 92 percent of her portfolio" and lost significant money, he said. "No client would've bought these investments if they knew what they were."[78]

As noted above, if investors facing steep losses choose to fight their brokers directly, they'll typically be compelled to use the industry's own arbitration forum, as nearly every brokerage firm requires investors to sign a mandatory binding arbitration agreement that waives their right to sue in court.[79]

Since the industry's self-regulator, FINRA, runs the securities arbitration forum, it's the equivalent of trying a malpractice suit in a system run by doctors (though arbitration panels do always include at least one "public," or non-industry, arbitrator).[80]

While arbitration can be less costly and much more efficient than court trials, complainants almost never get punitive damages, and may only appeal in the rare case of fraud involving an arbitrator.[81] In the vast majority of cases, according to industry observers, brokerage firms urge investors to settle for a fraction of what they lost.

It's not known if investors get a fair hearing when they use the industry's arbitration forum. Only settlement amounts that go through arbitration are made public,[82] leaving aside any deals cut outside of the arbitration process. And even these are only available in individual PDF files, making searches impossible. In addition, the industry does not always comply with state laws regarding fraud compensation.[83]

The arbitration panels also do not write opinions or explanations of how they arrived at their decisions. And no one but the attorneys,

AGENCIES PROBING STRUCTURED PRODUCTS:

FINRA
Financial Industry Regulatory Agency

SEC
Securities and Exchange Commission

NASAA
North American Securities Administrators Association

arbitrators and the complainant may attend the hearings unless both parties give written consent. Even regulators are forbidden from sitting in on hearings without this express written permission.

As some investors have discovered, even when they win, they lose — after they subtract FINRA's arbitration fee[84] and legal costs from an already meager settlement. NASAA, the North American Securities Administrators Association, studied this problem some years ago and compiled a report, but has refused to release it.†

> “A ‘win’ in arbitration often amounts to recovery of only a fraction of the losses incurred by the investor” – TANYA SOLOV, DIRECTOR OF THE ILLINOIS SECRETARY OF STATE'S SECURITIES DIVISION

In February, the SEC signed off on a new FINRA proposal to give investors the option of an all-public arbitration panel — meaning a panel without any industry representatives.[85] In addition, Dodd-Frank required the SEC study the mandatory arbitration of securities disputes and to consider allowing investors direct access to the courts.[86]

Louis Straney, the securities arbitration consultant based in New Mexico, reviewed hundreds of cases in 2008 and found that punitive damages are rare, awarded in perhaps 5 percent of cases. He also found that investors only win awards covering attorneys' fees and costs less than 15 percent of the time.[87] [88]

“A ‘win’ in arbitration often amounts to recovery of only a fraction of the losses incurred by the investor,” said Tanya Solov, director of the securities division of the Illinois Secretary of State, who participated in NASAA's unpublished study, mentioned above. “In certain circumstances, the sum awarded amounts to less than the costs and fees the investor paid out of pocket to pursue the case.”[89]

Like most of the state regulators I interviewed, Solov was highly critical of the FINRA arbitration system. She saw it as unfair that investors should have to pay fees to try to get their money back. Brokerage firms, with billions in resources at their disposal, can choose to delay and deny claims at will. Solov disputed the industry's claim that court trials for aggrieved investors would be more costly or burdensome.

“These cases aren't complicated,” Solov said. “Investors settle [with brokerage firms] out of frustration. Arbitration should be optional when there's unequal bargaining power. Investors should have a choice.”

Nearly all of the state regulators I interviewed, especially those in the most populous states, said they see structured products as part of a new wave of investor losses. As this report was being prepared, NASAA organized a task force to study structured/derivative products abuses, which have been reported in more than a third of the states I surveyed.[90]

† *I appealed to NASAA's board of directors to make the report public, but was denied.*

A Better Investor Protection Policy: Recommendations

Investors will never be reasonably protected unless they know, up front, in plain language exactly what they are buying.

They also need to be protected from the ravages of unmonitored, commission-based brokers and agents. The most meaningful improvement would be to make all brokers, financial advisors and agents fiduciaries, whose principal legal obligation is to protect their clients' best interests. Investors should have the ability to sue these professionals in a court of law if they are wronged.

In a welcome development, the SEC recommended in a January 2011 report that brokers become fiduciaries. But this idea is still only in the proposal stage, and it's not yet clear how stringent those rules might be, how soon they might be imposed or whether the SEC would have the funding to enforce them.[91] The agency's work has been imperiled by GOP congressmen who want to gut the Dodd-Frank law and severely curtail funding for the SEC and other regulators.[92] [93] SEC chairwoman Mary Schapiro told this reporter on April 8 that the fiduciary rule would be reconsidered in the second half of 2011 after the agency conducts more "economic analysis." The rule was opposed by the two Republican members on the agency board and has been lobbied against by the industry.[94] Schapiro also said the new rule was tabled for now, because the agency was more focused on meeting deadlines for new rules regarding derivatives.

Here are some recommendations for the SEC and Congress to consider that would promote long-term investor protection and retirement security:

TRANSPARENCY

- Completely overhaul the term sheets and prospectuses for structured products, retail derivatives and variable annuities.
- Require full disclosure in plain language on page one of the full costs and expenses of the product, its liquidity, a concise risk analysis and an exact assessment of how much of the investment could be lost. The disclosed expenses should include: commissions, underwriting fees, bid/ask spreads and all other internal costs. Investor warnings should be as clear and visible as those on tobacco products.
- Conflicts of interest between brokers, wholesalers, issuers and other third parties should be clearly explained on page one of all marketing materials given to clients.

APPROPRIATE SALES

- Structured/derivative product sales should be barred for retired or highly conservative investors. Someone should only be considered an eligible buyer if her or she is an accredited investor with more than $2 million in non-real estate assets.
- Exceptions should only be allowed if that person (a) has previously invested in options or futures, (b) has opened and understands a margin account and (c) has a basic knowledge of how derivatives work.
- Brokers, advisors and agents should be prohibited from selling structured products if the sale would weight a client's portfolio with more than 15 percent of the vehicles.
- Sales, transfers or rollovers from individual retirement accounts or other retirement funds into other investments without independent review by fiduciary advisors or planners should be prohibited.

- All financial advisors, brokers and agents should be required to present two low-cost alternatives to each complex, structured security they seek to sell.
- A certified list should be created by the SEC or another consumer protection agency of "safe harbor" products that feature low costs, guaranteed income and liquidity.
- If an investor demonstrates cognitive impairment, any asset sales or transfers should require the approval of an independent fiduciary, family member or attorney.
- Better reporting of suspicious financial transactions should be implemented that coordinates families, health care professionals, elder-law attorneys and aging specialists.
- The use by brokers of titles such as "senior" or "retirement" specialist should be barred by FINRA and the SEC except by professionals who are fiduciaries and experienced retirement planners. Certified financial planners, registered investment advisers and elder law attorneys are examples of fiduciaries.

ACCOUNTABILITY

- All brokers and agents selling financial products should be unequivocal fiduciaries who are legally bound to place the client's interests above those of the firm.
- A joint system between the SEC, FINRA and state regulators should record all consumer complaint information by firm and product. This data should be easily accessible online, or by phone or email request.
- Investors should be given the right to opt out of FINRA industry arbitration forums to access the civil court system and should be informed of this option upon signing of any brokerage agreement.
- FINRA should make available detailed profiles of arbitrators — including how they have ruled in each case they have heard — to all investors and their attorneys.
- FINRA should make settlement and arbitration data readily available to third parties such as regulators, researchers and investors.
- NASAA members should make complaint and enforcement action information available by firm and product, easily searchable online.
- Outreach and education needs to be improved to identify victims and provide assistance and intervention.

SAMPLE STRUCTURED PRODUCT DISCLOSURE

This is a suggested template for a complex derivative-based income or structured product disclosure:

WARNING: ***This product may be hazardous to your wealth. Do not invest in this product if you need the money to pay living expenses or can't afford any loss in principal.***

THIS PRODUCT IS SOLD BY BROKER X AND UNDERWRITTEN BY BANK Y. IT IS NOT GUARANTEED BY ANY FEDERAL AGENCY.

Can I lose money?

Yes, under certain conditions. There is the risk that your underlying investment will decline in value or that the issuer will go bankrupt. Your principal is not guaranteed.

How much will it cost me?

The broker commission is 10% annually (paid upon purchase). The bank underwriting fee is 1%. Both fees are non-refundable. If you invest $1,000, only $890 will be put to work. You will also incur a commission if you sell this product back to a broker plus any loss in principal.

Will I be able to get my money out quickly?

No, this is an unlisted security with little or no secondary market. Your broker may be able to buy it back, but at a 10% discount or more. Buyback is not guaranteed.

Is this product recommended for risk-averse, income-oriented investors?

No, only investors placing less than 10% of their total net worth should consider this investment.

What are the additional risks and conflicts of interest?

You may lose money on the bid/ask spread within the contract. Poor performance by the derivative contracts contained within the contract could also result in losses. There is a risk that the issuer will be unable to pay a return on the note. There may also be an options pricing risk, meaning you could lose money on embedded derivatives contracts, and an interest rate risk, meaning you could lose money if interest rates rise. The seller receives a fee from the issuing bank and may have other conflicts.

NOTE: *The disclosure form should also include a graph clearly showing the product's likely performance under best, moderate and worst-case scenarios, as well as a graph of a sample comparison of a non-structured product or portfolio.*

Conclusion

Will another financial crisis trigger the collapse of structured products? It's hard to say because most of the products escape full regulation and few are vetted for sale by regulators.[95] They could easily be headed for trouble and investors because they are, like the mortgage-backed securities that collapsed in 2008, based on opaque derivatives.

The underfunded SEC and the industry regulator FINRA simply can't keep up with problem products and scams. While FINRA issues periodic investor alerts and "member notices," the industry rarely bars even the most vexing investments.

Since FINRA does not post the number and amounts of settlements in an easily accessible way — one has to search broker by broker and download individual PDF files — comparisons are nearly impossible. In addition, the amounts of any settlements reached without going to arbitration may not be reported to FINRA at all. Who are the worst actors? What are the most dangerous products? How much are they costing investors? All of this information should be readily available, but is not.

Securities firms have latched onto a false argument: that the 2008 meltdown was a rare event and debacles like the Lehman Brothers failure were isolated problems. This has paved the way for complex, high-risk derivative products to continue to be sold to conservative, income-oriented investors.

"The sale of Lehman and other structured notes by UBS is a classic example of why doing business with a Wall Street firm is hazardous," said attorney Chris Vernon, who represents the Replogle and Brunhild families. "They periodically use their own client base — including many fixed income investors — as a dumping ground for defective products they cook up in their home office and then pitch worldwide to their financial advisors."

UBS, like other brokers, claimed that no one could have foreseen Lehman's catastrophic failure, although UBS had been lending money to Lehman and likely was aware of some of its financial woes prior to the crash.

Whoever was at fault, it's undeniable that thousands of investors were shorn of retirement funds by brokerage firms that should have known better — and brokers who either weren't told of the dangers of these investments or didn't choose to tell their clients.

Investors are still continuing to come forward to file arbitration claims against brokerage firms. Few will recover all that they lost. Yet structured products continue to come to market every day and are sold vigorously by every major brokerage firm.

While the new Consumer Financial Protection Bureau will not have oversight over the securities industry, the SEC has endorsed some changes that will help protect

investors, primary among them the recommendation to make brokers "fiduciaries" (see above) who will be legally liable if they ignore clients' investment objectives.[96] The agency needs to quickly finalize a strong pro-investor rule of this kind and work with FINRA to further overhaul investment disclosure and suitability rules.

Still, as long as the watchdogs are understaffed and underfunded and education for brokers and investors is lacking, investors won't be insulated from the securities industry. Congress should continue to generously fund the SEC and make its budget independent of politics, perhaps by linking it to securities transaction taxes.

Whoever was at fault, it's undeniable that thousands of investors were shorn of retirement funds by brokerage firms that should have known better — and brokers who either weren't told of the dangers of these investments or didn't choose to tell their clients.

This report doesn't assert that all structured products are bad or that a savvy investor can't find a suitable vehicle through an advisor. In terms of retirement security, though, the vast majority of investors would be better off seeking more transparent, lower-risk alternatives and employing an advisor who does not take a commission — and thus has no stake in recommending such products.

Investors will continue to be preyed upon as long as brokers, banks and insurers are allowed to place profits above the best interests of their clients. This practice needs to change if investors are truly to be protected.

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