

What Every Investor Should Know About Reverse Convertibles

A reverse convertible is a structured product designed to pay enhanced cash flow to investors willing to accept a number of risks. Too often, however, the risks are ignored or downplayed by brokers, who earn high commissions for selling them. Reverse convertibles are marketed to appeal to investors who are frustrated by low interest rates on traditional safe investments like CDs and money markets funds, but are unable or unwilling to accept the volatility of the stock market.

The facts that investors need to know about reverse convertibles include:

- A 2011 SEC staff report concluded that reverse convertibles, like other structured products, "are often quite complex and can present wide-ranging risks and regulatory issues, including suitability and disclosure concerns, limited liquidity, comparatively opaque and often expensive fee structures, paucity of secondary market activity and difficulty in pricing."
- The SEC staff report also found that brokerage firms have improperly sold reverse convertibles to investors. After examining sales of reverse convertibles by a number of large brokerage firms, the SEC staff found they were inconsistent with the customer's investment objectives and financial profile, that important disclosures had not been made, and that customers had suffered significant losses.
- Part of the reason why the SEC staff is concerned is because reverse convertibles are often characterized as conservative fixed-income investments when they actually pose a high risk of loss of principal and their returns are linked to often volatile equity prices.
- The Financial Industry Regulatory Authority (FINRA) has repeatedly warned investors about the problems and risks of reverse convertibles.
- An investor that is not familiar with the risks of options trading and qualified to trade high risk options should not invest in reverse convertibles. The so-called income on reverse convertible notes is actually, in part, a premium paid to the investor for selling the issuer a "put" option. The investor almost always has no idea of what a put option is, much less that he has sold one to the issuer.
- Often reverse convertibles involve payments of significant commissions to brokers, which can exceed 5%. In some cases, the commission percentage is higher than the potential yield to the investor. Other costs and fees, such as a fee for the issuer, are embedded in the price of the reverse convertible.
- It is all but impossible for investors to determine the size of costs associated with reverse convertibles or whether the pricing of a reverse convertible is a good deal. This is not only true of costs and pricing, but also of the significant risk of loss associated with reverse convertibles.
- A reverse convertible, despite promises of partial or contingent protection, is simply the unsecured obligation of the issuer. If the issuer defaults, as Lehman Brothers did, the investor is left with nothing except an unsecured claim against the (probably bankrupt) issuer.
- Reverse convertibles are typically not listed on any exchange, and the issuer is not required to buy them back. They are, therefore, illiquid (difficult to sell).
- These risks and problems are largely uncompensated. The investor does not own the linked asset, and therefore receives no dividends and only a watered-down part of any price appreciation.
- Reverse convertibles are so complex and opaque that most brokers do not understand them and, therefore, cannot adequately explain them to investors.



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