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Paging PT Barnum: Fees on some broker-sold notes exceed possible return

Complex reverse convertibles mostly sold to individual investors; 'inconceivable'

By Bloomberg News

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Brokers for Royal Bank of Scotland Group Plc, JPMorgan Chase & Co. and Barclays Plc are charging fees on some structured notes that equal or exceed the securities' highest possible yield, as sales of the opaque products draw scrutiny from regulators.

On June 15, RBS gave brokers a 2.75 percent commission to sell a three-month reverse-convertible note with a 2.56 percent potential yield, according to a prospectus. Last month, JPMorgan charged 5.25 percent in fees and commissions on a three-month Citigroup Inc.-linked note that paid 5 percent interest, and Barclays offered brokers a 2 percent commission on a security paying 2 percent interest, according to other prospectuses.

Charging fees higher than the potential yield on a reverse convertible is “rare,” according to Durraj Tase, who supervised structured-note sales at U.S. Trust. Banks sold $460 million of the notes in the U.S. in May, with disclosed commissions and fees averaging 2 percent for six months, according to data compiled by Bloomberg.

“It seems inconceivable that the commission could be more than the potential return to clients,” said Tase, who is now a high-net-worth adviser with First Liberties Financial in New York. “If you are paying more fees than your potential return, as an adviser, I would not be able to suggest that note.”

The Financial Industry Regulatory Authority, the industry- funded brokerage regulator, has made sales of structured notes, including reverse convertibles, a priority for its examination and enforcement divisions, according to a March 1 letter to brokers.

Pholida Phengsomphone, a spokeswoman for RBS, Britain's largest government-owned bank, declined to comment. Justin Perras, a spokesman for New York-based JPMorgan, and Kristin Friel, a spokeswoman for London-based Barclays, also declined to comment.

Reverse convertibles generally pay higher interest rates than corporate bonds, with last month's notes yielding an average of 15.7 percent per year, Bloomberg data show. Their risk lies in so-called down-and-in put options built into the products that allow banks to repay buyers with shares if an underlying stock declines a certain amount. Investors in RBS's note could lose money if Alcoa Inc. drops by more than 25 percent.

Down-and-in put options aren't traded on exchanges, making them difficult to value without a computer model. The customized contracts are privately negotiated by banks and their clients in the $615 trillion over-the-counter derivatives market, where trades and prices aren't reported publicly.

Brokers often ask banks to create reverse convertibles for their clients with specific terms, and share in the fees, according to Deryk Rhodes, a senior vice president who distributes structured notes for Newbridge Securities Corp. in Fort Lauderdale, Florida.

Most of the products are sold to individual investors, said Chris Warren, New York-based head of structured products at DWS Investments, the asset management arm of Deutsche Bank AG, which oversees $133 billion. Short-term reverse convertibles generally have higher annualized commissions than other structured notes, he said.

“Investors would be well served to ask themselves why substantial commissions are apparently needed as a sales incentive,” Warren said in an e-mail on June 18. He declined to comment on the RBS, Barclays and JPMorgan notes.

Finra fined H&R Block Financial Advisors Inc. $200,000 in February for failing to adequately supervise reverse-convertible sales. H&R Block neither admitted nor denied the charges. Finra sent a letter to brokers at the time saying sales pitches for the securities should be “fair and balanced” and posted an alert to investors on its website.

“Reverse convertibles may be very appealing on a superficial level, but the devil's in the details,” said John Gannon, a senior vice president of investor education at Finra in Washington in a June 21 interview. He also declined to comment on the RBS, Barclays and JPMorgan notes. “It's tricky to assess the chances of getting your principal back.”

Undisclosed costs, such as a profit for the issuer, are generally included in the notes' sale price, according to Finra. It is “all but impossible” for investors to determine the size of these costs or “whether the reverse convertible represents a good deal,” Finra said on its website.

“It's pretty easy to build in extra fees because retail investors aren't in a position to price the embedded options,” said Janet Tavakoli, founder of Chicago-based consulting firm Tavakoli Structured Finance, in a June 16 telephone interview.

RBS sold $375,000 of its Alcoa-linked reverse convertibles, according to the prospectus. If shares of the aluminum maker close more than 25 percent below their initial level on any day during the note's three-month term, the down-and-in put option is triggered, and investors receive the stock at maturity, instead of their principal.

Investors in JPMorgan's reverse convertibles, which pay 5 percent interest over three months, are exposed to losses if Citigroup declines more than 20 percent. JPMorgan collected a 5.25 percent fee for selling $784,000 of the securities on May 25, according to the prospectus. Barclays' $1 million offering on May 10 is linked to the stock of Apple Inc., with the option triggered if shares drop more than 25 percent.

While RBS's Alcoa-linked note pays more interest than a corporate bond, the embedded down-and-in put option makes the two difficult to compare, said William Larkin, who helps oversee $500 million as fixed-income portfolio manager at Cabot Money Management in Salem, Massachusetts.

“That interest rate is going to instantly get my attention,” Larkin said in a telephone interview on June 16. “But if I buy a bond, I'd rather get a fixed rate for a fixed term, rather than buying a black box with different contracts.”