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JPMorgan's 64 Percent Note Shows Risks of Reverse Convertibles

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A JPMorgan Chase & Co. reverse-convertible note paying 64 percent annualized interest plunged in value on May 14, three days after being sold, showing the risks of these products usually bought by individual investors.

The structured notes offered 10.7 percent in interest payments over their two-month term and a return of principal, as long as shares of TiVo Inc. didn't fall more than 25 percent, according to a prospectus. TiVo dropped 42 percent on May 14 after an adverse court ruling, triggering a provision that will leave investors holding the possibly depressed stock at maturity.

Banks including JPMorgan, Morgan Stanley and Barclays Plc sold \$656 million of reverse convertibles in the U.S. last month, according to data compiled by Bloomberg.

The securities, which combine features of bonds and stock options, are often sold to individuals who don't understand the risks, said Jake Zamansky, a New York-based attorney who represents investors.

"It's being sold as a bond, an income-generating product, and I don't think it's being explained to people that you can get stuck with the stock," the securities lawyer at Zamansky &

Associates said in a telephone interview on May 14. He has represented investors in lawsuits related to the products.

Justin Perras, a JPMorgan spokesman, declined to comment. The prospectus's listing of risk considerations includes the statements "your investment in the notes may result in a loss" and "your protection may terminate on any day." "Protection" refers to the feature where the principal is returned unless, on any day, the stock closes 25 percent below its initial price.

Receiving Stock

Because that level was breached, noteholders will receive at maturity as many shares of the stock as their investment would have bought at the initial price, hence the name "reverse convertible."

"Individuals should be buying reverse convertibles on stocks that they otherwise would consider owning outright," said Keith Styrcula, chairman of the New York-based Structured Products Association, in a telephone interview today.

Investors in JPMorgan's notes could make money if TiVo's share price recovers. The stock was up 5.8 percent, to \$10.75, at 1:09 p.m. today in trading on the Nasdaq

Stock Exchange, compared with \$16.88 when the notes were issued.

JPMorgan sold \$800,000 of the TiVo-linked products, it said in the prospectus. The 64 percent interest rate was the highest offered on any reverse convertible in months, according to Craig McCann, a Fairfax, Virginia-based litigation consultant who's preparing a study of the market.

'Ridiculous' Commission

The price of the securities included a 1.75 percent sales commission, of which JPMorgan received 0.75 percentage point, according to the prospectus. That's 10.5 percent on an annualized basis, which is much higher than the commission charged on comparable investments, according to Seth Lipner, a Garden City, New York-based attorney.

"A 10.5 percent commission is ridiculous," Lipner said in a telephone interview on May 14. "The cost would be much lower" for investors to make the same kind of market bet using various options rather than reverse convertibles, he said.

Structured notes generally include other costs, such as to offset risks related to the security, as well as a profit for the issuer. The built-in costs of the TiVo-linked note were limited to the 1.75 percent commission, according to the prospectus.

Each \$1,000 TiVo note was worth \$945 on the day it was offered, according to Bloomberg's reverse-convertible pricing model. McCann said his model came up with an initial value of \$960. Prices generated by the models vary based on the source of market data and assumptions about liquidity and volatility.

Court Case

TiVo's decline came after an appeals court said on May 14 it would reconsider the company's victory over Dish Network Corp. and EchoStar Corp. in a digital-video recording patent case. Dish and EchoStar had

asked on April 5 for the full panel of the appeals court to rehear the case.

"I don't think something with a major development about to take place, positive or negative, should be put into a reverse convertible," Zamansky said. "There's just too much volatility."

JPMorgan's prospectus states that TiVo's stock "has experienced significant fluctuations." It doesn't mention the pending patent case.

Many investors who lost money on reverse convertibles have filed arbitration claims against their brokers, according to Zamansky. The Financial Industry Regulatory Authority, a trade group, said in a February letter to its members that reverse convertibles can be "difficult for retail investors and registered representatives to evaluate." Brokers' sales pitches must be "fair and balanced," it said.

Brokers often market reverse convertibles as a way for individuals to take advantage of the sophisticated derivatives trading that banks use, according to Chris Vernon, a Naples, Florida-based attorney who represents structured-note investors.

"The pitch with these complex structured products is that this is what the big boys are doing and now you can do it too," Vernon said in a telephone interview on May 14. "But the big boys aren't paying 10 percent-plus commission per year."