



Levelling the playing field

As growth in the European markets in particular continues, Chairman of the US Structured Products Association Keith Strycula maps out the road ahead for Structured Products...

The last two years have seen unprecedented growth in the development and distribution of structured products in the United Kingdom, the United States and Europe. To use the New York Stock Exchange definition, structured products are 'investment products that are based on an underlying security such as a single equity, a basket of stocks, an index, a commodity, a debt issuance or a foreign currency'. Once exclusively the province of banks and securities firms marketing to institutional and ultra-high net worth individuals, the retail market for these products is developing globally at breakneck speed. A key to this rapid growth is continued marketplace innovation and positioning of structured products in both the retail and institutional arenas. However, the rewards of innovation and positioning are not without their legal and credit risks.

The United States

The most critical legal concerns in the development and distribution of structured products in the United States will continue to revolve around disclosure and suitability, particularly in the retail arena. These concerns heighten the need for diligence on the part of broker-dealers, in terms of both fully understanding their customers and highlighting the risks

involved on a product-by-product basis. In-depth analysis and understanding of the products, followed by balanced explanation of the risks and rewards, will become increasingly more important as issuers offer complex products whose features may elusively appear to be only slightly different from those offered by a competitor.

Further to the foregoing, since the world of structured products often blurs the distinction between debt and equity, tax characterisation of products, especially more exotic offerings in both the retail and institutional market, will continue to be a challenge. The adequacy of personnel training will continue to be a sensitive issue in promoting customer specific suitability and will require, at a minimum, a keen understanding as to the differentiation of the structured product relative to a direct investment in the underlying asset to which it relates.

Risk management practices for financial institutions (banks, savings and loan associations, bank holding companies, and registered broker-dealers and investment advisers) will also continue to be of primary concern, particularly for those complex structured finance transactions that pose elevated legal or reputational risk to the institution.

Because regulatory guidance relating to structured products in the US is principles-based and not intended to dictate a 'one size fits all' framework, financial institutions bear a significant onus in (a) identifying which products pose an elevated risk, (b) adopting a meaningful framework for reviewing and approving such products, (c) developing a due diligence, approval and documentation process for such products, and (d) adopting other risk management policies promoting good business ethics, all towards mitigating credit, legal and reputational risks.

The July 2007 inquiry, launched by the Secretary of the Commonwealth of Massachusetts William F Galvin into the sales practices of broker-dealers in Massachusetts that sell structured products to retail investors, is but one example of the scrutiny that regulators may apply to compliance and supervisory procedures utilised by financial institutions.

As an essential component of risk management and regulatory compliance practices, technology will also need to keep pace of the developments in the structured products marketplace. This will pose timing issues: technological innovation will need to happen even more quickly in order to keep up with the development of new structured products. The sophistication of service oriented architecture (SOA) will continue to be a sine qua non of risk modelling, monitoring and tracking of structured products. However, the efficacy of service-based technology depends on properly trained personnel. In the structured products area, the operational risk of a transaction will need to account for the sophistication of its SOA personnel and their understanding of the business applications for which the technology is being designed.

Financial innovation and positioning of structured products in the United States will also have to gauge the appetite for particular products within different consumer groups in order to keep up with investor demand. In addition to the growing retail market, pension funds, family offices, foundations and endowments are expanding their holdings in structured products, as well as other alternative investment strategies. This growth has spurred financial advisers to analyse matters such as liquidity, capital protection, correlation (or lack thereof) with traditional debt and equity securities, volatility, leverage and strategy diversification – and lawyers to delve more deeply into tax and employee benefit law concerns. Convergence of financial product markets, such as registered mutual funds that offer hedging strategies, is still in its infancy. As convergence of previously divergent markets becomes more mainstream, the opportunities – and the challenges – will multiply.

The United Kingdom and Europe

The market for structured products in the United Kingdom and the rest of Europe is also strong and growing rapidly, both in terms of overall volume and the number of products available. The market for retail structured products is also expanding quickly and in certain jurisdictions, particularly

Germany and the Netherlands, is relatively mature compared with the United States.

Many of the issues highlighted above are equally relevant in the European markets, in particular questions as to whether adequate disclosure of the relevant product is made to enable investors to make a well considered investment decision. A number of European regulators, including the FSA in the UK and the AFS in the Netherlands, have issued recent policy statements and discussion papers focusing on disclosure and other issues relevant to structured products. There have also been discussions as to the respective role of the product providers and distributors in ensuring that a particular product is suitable for the investors who are likely to purchase the product and an appropriate description of the product is provided to those investors.

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The regulation relevant to structured products in the European markets is harmonised, particularly in respect of the wholesale markets, to a significant extent by EU legislation. The Markets in Financial Instruments Directive ('MiFID') is scheduled to be implemented in November of this year. This partly consolidates existing rules but may have significant impact on information that financial institutions are required to provide to their clients, particularly where providing advice. Where structured products are issued in the form of securities, the Prospectus Directive, which came into force in 2005, is intended to provide a simple 'passporting' system to allow securities approved by the competent authority in one jurisdiction to be offered in other member states without further approvals being required. There are some 'teething' issues, particularly in relation to the retail markets, that need to be addressed but it is likely that a continuing levelling of the regulatory playing field across the European markets will help to continue the growth of structured products across the European markets.



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