

DEVELOPMENTS IN THE STRUCTURED PRODUCTS MARKET

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Outline

- EU regulatory proposals relating to retail structured products:
 - PRIPS
 - complex and non-complex products under MiFID
 - Prospectus Directive – proposed amendments
 - UCITS IV
 - proposed Alternative Investment Fund Managers (AIFM) Directive
- IOSCO consultations and reports
- FSA initiatives relating to retail structured products
- Industry recommendations
- Impact of proposals on structured products market

Packaged Retail Investment Products ("PRIIPS")

- EU Commission Communication, 30 April 2009
- Follows on from Call for Evidence in relation to substitute investment products in 2007
- Concern as to inconsistency of regulatory approach for different products
- Commission propose a horizontal approach in particular in relation to regulation of disclosures and selling practices

PRIPs (cont.)

- Features generally include;
 - exposure to underlying assets in a packaged form
 - generally aimed at capital accumulation
 - generally designed for mid to long term retail market
 - often marketed directly to retail investors
- Types of products include:
 - funds: UCITS and non UCITS
 - life insurance policies
 - structured securities
 - structured term deposits

PRIPs (cont.)

- Key elements of regulation of PRIPs includes:
 - form and content of key investor disclosures and associated materials
 - conduct of business rules for product distributors and management of conflicts of interest
- Currently a combination of product based directives and cross-cutting legislation targeting particular sales channels or commercial practices
- PRIPs therefore subject to different rules depending on their legal form and channels through which they are sold

PRIPs (cont.)

	UCITS	Non-harmonised investment funds	Unit-linked life insurance policies	Structured securities and closed-end funds	Structured term deposits
Rules on product information applying to manufacturers issuers or intermediaries	Simplified Prospectus of UCITS Directive	MiFID (High level product disclosure requirements apply to MiFID intermediaries when selling financial instruments)	Consolidated Life Directive	Prospectus Directive	No rules at EU level
	MiFID (High level product disclosure requirements apply to MiFID intermediaries when selling financial instruments)		IMD for some product disclosure requirements	MiFID (High level product disclosure requirements apply to MiFID intermediaries when selling financial instruments)	
	E-commerce Directive or Distance Marketing of Financial Services Directive				
Selling Rules	MiFID	MiFID	IMD	MiFID	No rules at EU level
	UCITS Directive				
	E-commerce Directive or Distance Marketing of Financial Services Directive				

PRIPs (cont.)

- Proposals in relation to key investor disclosure aimed at harmonising and standardising key retail disclosures accepting the need for tailoring for certain products
- Key principles include:
 - product disclosure should be fair, clear and not misleading
 - disclosure should be comprehensible to target investors
 - information necessary to take an informed investment decision
 - as far as possible disclosures should promote comparisons between different products
 - should be provided in a timely fashion to investors
 - associated marketing communications should be fair, clear and not misleading
- UCITS “KII” regarded as benchmark

PRIPs (cont.)

- Information required to be included in disclosure documents includes:
 - name and details of product manufacturer
 - aims and mechanism for achieving aims
 - risks and benefits
 - costs and fees
- Key points of comparison to be considered
- Wrappers

PRIPs (cont.)

- Key elements of horizontal approach to selling practices are to provide consistent conduct of business, inducement and conflicts provisions
- MiFID regarded as benchmark
- Key principles include
 - selling practices should be focused on fair treatment of the investor
 - any investment advice must include advisor undertaking necessary steps to ensure products correspond to the needs of the investor and the investor understands the product
 - if sold without advice, the limits to the service provided and the risks for the investor must be clearly communicated
 - conflicts of interest should be avoided where possible and otherwise must be identified, managed and disclosed in a way the investor can understand
 - investors must receive clear and effective disclosure of remuneration arrangements and charges, commissions or fees paid
 - those assessing the suitability of products must fully understand the products and their features

MiFID – Complex and Non-complex instruments

- MiFID appropriateness test
 - firm must request information from client regarding knowledge and experience to enable the firm to assess whether the service or product is appropriate for the client
- Article 19(6) provides an exemption for execution only services if:
 - services relate to shares admitted to trading on a regulated market, money market instruments, bonds or other forms of securitised debt (excluding bonds or securitised debt that embeds a derivative), UCITS and other non-complex financial instruments
 - the service is provided at the initiative of the client
 - the client has been warned that it will not have the benefit of a suitability assessment
 - the firm complies with its MiFID obligations re conflicts of interest
- Article 38 of the level 2 Directive specifies criteria that instruments must satisfy to be regarded as non complex

MiFID – Complex and Non-complex instruments (cont.)

- CESR Consultation Paper published 14 May 2009
- Feedback statement published 3 November 2009
- Shares
 - traded on a MTF
 - non-UCITS undertaking
 - convertible/exchangeable shares
- Money market instruments
- Bonds or after securitised debt (not embedding a directive)
- UCITS and non UCITS funds (including ETFs)
- Other non-complex financial instruments

MiFID – Complex and Non-complex instruments (cont.)

- Instruments regarded by CESR as embedding a derivative
 - credit linked notes
 - structured instruments where performance is linked to the performance of a bond index, a basket of shares (with or without active management and whether or not guaranteed)
 - convertible and exchangeable bonds
 - structured instruments whose performance is linked to the performance of another underlying such as a commodity or commodity basket
- MiFID Review

Proposed Amendments to Prospectus Directive

- Draft Directive published September 2009
- Amendments suggested in a number of areas
- Retail cascade:
 - permitted if issuer consents to use of prospectus
 - FSA List! 16
- Prospectus summary:
 - key information
 - extension of liability
- Prospectus supplements
- Validity period extended to 24 months

AIFM Draft Directive

- Draft EU Directive on Alternative Investment Fund Managers
- Published on 30 April 2009
- Aims to create comprehensive and effective regulatory and supervisory framework for AIFMs in the EU
- AIFMS are defined as all funds that are not regulated under the UCITS Directive
- EU Commission believe financial crisis has highlighted that AIFM are vulnerable to various risks including macro prudential and micro prudential risks

AIFM Draft Directive (cont.)

- Directive covers all AIFMs above certain size thresholds:
 - does not apply to AIFMs managing a portfolio not exceeding €100m (€500m where the portfolio consists of AIF that are not leveraged and with no redemption rights exercisable within 5 years of the establishment of the AIF)
 - does not apply to AIFM established in the EU which do not provide management services to AIF domiciled in the EU and do not market AIF in the EU
- Member states must not permit an AIFM covered by the Directive to provide management services to any AIF or market shares or units therein
- To obtain authorisation, an AIFM will need to provide detailed information to its competent authority in relation to its ownership, governance and activities

AIFM Draft Directive (cont.)

- Conduct of business rules
 - general principles
 - conflicts of interest
 - risk management
 - liquidity management
 - securitisation positions
- Capital requirements
 - minimum own funds of EUR 125,000
 - if value of managed portfolios exceeds EUR 250m, the requirement is increased by 0.02% of the excess

AIFM Draft Directive (cont.)

- AIFMs intending to delegate functions require prior authorisation from the competent authority
- Certain conditions must be met in relation to such delegation including
 - creditworthiness, good reputation and experience
 - delegation must not prevent effective supervision of AIFM or prevent AIFM from acting in best interest of investors
 - selected with due care and diligence
- Annual report to be required by AIFM in respect of each managed AIF
- AIFs will be required to appoint an independent regulated credit institution to custody assets

AIFM Draft Directive (cont.)

- AIFM shall ensure investors receive certain information before investing in an AIF and any changes thereto including:
 - description of investment strategy and objectives (including details on permitted leverage)
 - procedures by which AIF may change investment strategy or policy
 - identity of depository valuer, auditor and other service providers
 - details of any delegation
 - description of liquidity risk management
 - description of all fees, charges and expenses and the maximum amounts thereof directly or indirectly borne by investors
 - any preferential treatment for certain investors
- AIFM is also required to make regular reports to its competent authority of the principal markets and instruments in which it trades and provide other information periodically

AIFM Draft Directive (cont.)

- An authorised AIFM meeting the conditions in the Directive may market shares or units in AIF to **professional investors** in its home member state
- Member states may allow the marketing of AIF to retail investors in their territory
 - For such purpose they may impose strict requirements on the AIF/AIFM
 - Member State must notify the Commission of the types of AIF which may be marketed to retail investors
- Passporting provisions apply to marketing by an AIFM in another Member State
- An AIFM may only market shares or units in an AIF domiciled in a third country to professional investors domiciled in a Member State if such country has signed an agreement with the Member State complying with Article 26 of the OECD Model Tax Convention and ensures an effective exchange of tax information
- Member states may authorise an AIFM established in a third country to market shares or units of an AIF to professional investors in the EU provided certain conditions are met
 - The commission has adopted implementing measures stating the legislation on prudential regulation and ongoing supervision of AIFMs in such third country is equivalent to the Directive
 - A cooperation agreement is in place between the competent authorities of the EU Member States and those in the third country
 - The Member State and the third party have signed an agreement complying with Article 26 of the OECD Model Tax Convention

AIFM Draft Directive (cont)

- Directive generally follows a ‘one size fits all approach’
- There are however additional rules for specific types of AIF
 - additional obligations for AIFMs managing one or more AIFs employing high levels of leverage on a systems basis
 - additional obligations for AIFMs managing AIF which acquire controlling influences in complies

AIFM Draft Directive (cont)

- Conditions of the Directive include
 - ‘one size fits all’ approach
 - difficulty of funds outside the EU to be passported into the EU
 - other ‘protectionist’ measures including limiting custodianship to EU registered credit institutions
 - some rules may disproportionately affect small forms (eg fixed leverage limits)
 - cost of non-EU funds complying with the Directive may lead to them leaving the EU
 - proposals could lead to less choice
 - some organisational requirements are over prescriptive and may be counter productive (e.g. the requirement to appoint an independent valuer)

AIFM Draft Directive (cont)

- Sweden as president of the EU Council has proposed various amendments