

# Regulatory Initiatives Affecting Structured Products

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# Overview

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- Packaged retail investment products (PRIPs)
- ESMA Consultation re Prospectus Directive
- Review of Markets in Financial Instruments Directive (MiFID)
- Product intervention
- FINRA Guidance
- Dodd-Frank

# PRIPs - Background

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- Proposal is to create a more consistent approach for regulation of packaged retail investment products irrespective of how the product is packaged
- It is envisaged the PRIPs legislation will cover at least the following products:
  - investment funds
  - structured securities
  - certain life insurance policies
  - structured deposits

# PRIPs - History

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- PRIPs process has included a number of calls for evidence and consultations including:
  - European Commission Call for Evidence – October 2007
  - EU Commission Communication – April 2009
  - Report of the 3L3 Task Force on PRIPs – October 2010
  - EU Commission further Consultation on PRIPs – 26 November 2010
  - EU Commission MiFID Review Consultation – 8 December 2010

# Scope of PRIIPs

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- Commission acknowledges difficulty of establishing a clear definition of a PRIIP but considers objectives should be to
  - encompass key packaged investment products currently being marketed in the EU
  - be flexible enough to cover new products as they develop
  - avoid incentivising regulatory arbitrage
  - provide sufficient legal certainty as to the products covered

# PRIPs – Key Characteristics

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- Commission believes key characteristics of PRIPs is that they are
  - “manufactured” by a firm
  - packaging different assets or elements of an investment together through
    - (i) wrapping a financial asset within another structure (e.g. UCITS or structured note, or
    - (ii) providing investment management through a collective investment scheme, or
    - (iii) devising a financial instrument creating exposure to other instruments, indices or reference values

# Proposed Definition of PRIPs

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- “A product where the amount payable to the investor is exposed to fluctuations in the market value of assets or payouts from assets, through a combination or wrapping of those assets, or other mechanisms than a direct holding”
- Consideration of “white list” of PRIPs
- Definition does not embed retail element but it is intended that disclosure and selling rules should only apply to sales to retail investors

# PRIPs – Disclosure Requirements

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- EU Commission proposes development of new disclosure framework applicable to PRIPs generally – “Key investor information disclosure”
- UCITS “KII” regarded as benchmark
- Objective is harmonisation and standardisation of key disclosures:
  - product disclosures and any associated marketing communications should be fair, clear and not misleading
  - information necessary to allow investor to take an informed investment decision
  - allowing for comparison between products
  - some tailoring permitted
- Issue as to whether KIID should be a document separate from any other prospectus or background document
  - interaction of PD summary section and KIID not yet clear

# PRIPs – Disclosure Requirements – Issues for further consideration

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- Risk considerations – inclusions of simple risk indicator?
- Costs – aim is to enable easy comparison between different products
- Approach in relation to information on performance
- Information to enable comparability between guarantees or capital protection for PRIPs
- Responsibility for KIID preparation – likely to be product manufacturer in most cases
- Obligation to update KIID?
- Development of KIID template:
  - template produced for UCITS KIID is very prescriptive
  - JAC submissions and proforma template

# PRIPs – Selling Practices

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- Key elements identified by the Commission are:
  - conduct of business rules
  - inducements
  - conflicts of interest
- MiFID regarded as benchmark
- Now being dealt with as part of MiFID review considered below

## **PRIPs Selling Practices – Key Principles Identified by Commission**

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- Selling practices should be focused on fair treatment of the investor
- Advised sales – the advisor must undertake steps to ensure the product is consistent with investor needs and investor understands the product
- Non-advised sales – there must be clear communication of the limits to the service provided and risks to the investor
- Conflicts of interest should be avoided or properly managed and disclosed
- Clear and effective disclosure of fees, charges and commissions
- Those assessing suitability of products must fully understand them

## ESMA Consultation on Prospectus Directive

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- Prospectus Directive sets out framework for prospectuses for EU securities offerings
- PD recently amended
- ESMA has recently published consultation paper relating to format and content of final terms
- Responses to consultation due by 15 July 2011
- ESMA to report to EU Commission by 30 September 2011

# ESMA Consultation on Prospectus Directive (cont.)

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- Base prospectus and any supplement need to be approved by relevant competent authority
- Final terms for each issue do not need to be approved:
  - provide economic terms of relevant issue
  - some flexibility to provide additional information under previous CESR guidance
  - current market practices vary
- ESMA believe there should be a more restrictive approach to final terms

# ESMA Consultation on Prospectus Directive (cont.)

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- ESMA has proposed a prescribed list of items from the applicable securities note schedules of the Prospectus Regulation indicating whether such item can be included in the final terms
- Category A
  - must be included in base prospectus – no additional information in final terms
- Category B
  - base prospectus must contain all general principles. Placeholder for final terms permitted for details not known at time of approval of base prospectus
- Category C
  - form of final terms may contain a placeholder for such information. Information may not replicate information from base prospectus

# ESMA Consultation on Prospectus Directive (cont.)

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- Issues of particular relevance for structured products:
  - for securities linked to an index composed by the issuer, the description shall not be included in the final terms
  - any information relating to the redemption structure of underlying securities should be in the base prospectus
  - general principles of the manner of redemption and settlement procedure of underlying security should be in the base prospectus
  - market adjustment and extraordinary events and consequential amendments should be set out in full in the base prospectus
  - final terms may not amend or replace any information contained in the base prospectus

# ESMA Consultation on Prospectus Directive (cont.)

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- ESMA proposes a summary of each individual issue should be annexed to final terms:
  - interaction with PRIPs initiative
  - no word count limit
- Requirements for content and style of summary include:
  - should contain key information
  - should be short, simple, clear and easy for target investors to understand
  - fresh assessment of key information in prospectus – not a copy out of text in base prospectus
  - no “boilerplate”
  - risk factors should highlight key risks relating to issuer and securities

# UK – Product Intervention

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- January 2011 Discussion Paper
- Previous approach of “point of sale” regulation
- New proposed interventionist stance
  - “where resulting benefits to majority from not being mis-sold a product outweigh costs to the minority who might benefit from being able to access it”
- Features more likely to provoke FSA intervention – complexity, cross-subsidy, conflicts of interest, layers of charging, teaser rates, exit charges, product names implying safety/return, difficult to assess performance risks.

# UK – Product Intervention (cont.)

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- Additional intervention powers being considered by FSA
  - Pre-approval / pre-notification of products
  - Banning products
  - Banning product features
  - Pricing interventions
  - Increased prudential requirements (incl. capital requirements)
  - Consumer warnings
  - “Wealth” warnings
  - Preventing non-advised sales
  - Limiting sales to certain classes of clients
  - Competence requirements for advisers

# UK – Product Intervention (cont.)

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- June 2011 Feedback Statement – 84 responses
- Consumer groups/industry groups
- Point of Sale approach still critical, but not sufficient
- Disparity with rest of Europe? Arbitrage?
- Single set of rules and guidance - RPPD

# UK – Product Intervention (cont.)

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- Additional product intervention options:
    - product pre-approval/notification – no plans for general pre-approval/notification
    - banning products/features – still to be available to prevent significant detriment
- Also, note powers of new FCA and EU Commission stance
- price intervention – overall charges, benchmarking, price capping. Unpopular but still under consideration
  - increased prudential requirements on providers – blunt instrument
  - mandated risk warnings – to be used sparingly, if supported by evidence
  - preventing/limiting methods of sales (non-advised) or types of customer – remains an option where FCA identifies vulnerable customers

# Financial Conduct Authority

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- 3 operational objectives:
  - securing appropriate degree of protection for consumers
  - promoting efficiency and choice in the market for financial services
  - protecting and enhancing the integrity of the UK financial systems
- Discharge functions so as to promote competition
- Will have wide power to make general rules restricting/prohibiting authorised persons from entering into agreements exposing them economically to specified products

# MiFID - Overview

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- MiFID fully implemented on 1 November 2007
- MiFID's aim is to set out high-level provisions governing the organisational and conduct of business requirements that should apply to firms engaging in investment business and to harmonise certain conditions governing the operation of regulated markets
- Sets out obligations of firms in respect of:
  - Client classification
  - Due diligence
  - Transaction reporting/ transparency
  - Best execution
  - Inducements
  - Conflicts of interest

# MiFID – Client classification

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- Clients of an investment firm must be categorised into following categories:
  - Eligible counterparties
  - Professional clients
  - Retail clients
- Some overlap between eligible counterparties and professional clients
- Clients may be reclassified, subject to certain safeguards
- Eligible counterparty regime limited to dealing on own account and receiving, transmitting and executing orders on behalf of client:
  - Firms dealing with eligible counterparties do not need to comply with conduct of business requirements

# MiFID – Due Diligence

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- Deals with due diligence to be conducted by firms before provision of investment services (not relevant to eligible counterparty regime)
- Three different levels:
  - Suitability (portfolio management or investment advice)
  - Appropriateness
  - Execution only (no due diligence required)
- Suitability covers client's:
  - Knowledge and experience
  - Financial situation
  - Investment objectives
- Appropriateness covers client's:
  - Knowledge and experience
- Certain assumptions allowed for professional clients:
  - That professional clients have requisite knowledge and experience
  - In respect of suitability test for investment advice, that professional clients (other than opted-up retail clients) financially can bear risk of loss

# MiFID – Execution-only Exemption

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- Provides exemption to performing appropriateness determination
- Only applies if:
  - Service is limited to reception and transmission of orders or execution of orders on behalf of clients
  - Service relates only to non-complex instruments
  - Service is provided at the initiative of the client
  - A prescribed warning is given to the client
  - The firm complies with its conflict management obligations

# EU Commission MiFID Review

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- EU Consultation Paper published on 8 December 2010
- Legislative proposals expected in October 2011
- Conduct of business and conflicts of interest rules to be extended to:
  - Advised and non-advised sales of structured deposits
  - Firms selling their own securities to clients even on a non-advised basis
- Client classifications largely unchanged
  - Some exceptions regarding “complex” instruments

# EU Commission MiFID Review (cont.)

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- Introduction of concept of Organised Trading Facility (OTF)
  - Any facility or system operated by an investment firm or market operator that brings together buy and sell orders in relation to financial instruments on an organised basis
  - Likely to catch broker crossing systems and interdealer broker system
- OTFs will become subject to certain MiFID requirements including:
  - Authorisation requirements
  - Reporting rules
  - Transparency obligations
  - Conflicts of interest rules

## EU Commission MiFID Review (cont.)

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- Introduces requirements for OTC derivatives that supplement the draft European Market Infrastructure Regulation (“EMIR”) proposals including:
  - all trading in sufficiently liquid derivatives should be effected through a regulated market, MTF or OTF
  - transaction reporting

## EU Commission MiFID Review (cont.)

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- Existing MiFID pre and post trade transparency regime for equity markets to be extended to all bonds and structured products which are admitted to trading on a regulated market or MTF and all derivatives eligible for central clearing or reported to a trade repository

## EU Commission MiFID Review (cont.)

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- Commodity firms and commodity derivatives
  - review of exemptions for commodity firms
  - reporting of position information
  - increased regulation of commodity derivatives
- Other matters subject to the Review include:
  - additional requirements on automated trading/high frequency trading
  - alignment of organisational requirements of regulated markets, MTFs and OTFs
  - greater reinforcement of supervisory powers and ability to intervene in derivative contracts

# EU Commission MiFID Review - Complex v Non-complex products

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- Two possible options outlined
  - Option 1:
    - Minor adjustments to Article 19(6)
  - Option 2:
    - Abolition of execution-only exemption
    - Appropriateness test will then always be needed for non-advised financial services to retail investors

# Regulatory Developments in the United States

# Critiques of structured products

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- Structured products are not suitable for any investor, as they simply repackage otherwise available assets at a cost.
- Subject to credit risk.
- Lack of liquidity.
- Full of conflicts of interest.
- The popular financial press is still raising concerns regarding whether investors understand the structured products that are being marketed to them.
- The growth in structured product sales in the U.S., especially to retail investors, has piqued interest of regulators and industry groups.
- Attacks on the legitimacy of structured products as suitable for retail investors.

## Substantial Regulatory Scrutiny in the U.S.

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- A response to, among other things, a significant amount of criticism in the mainstream business media.
- FINRA actions
- FINRA arbitrations (principally involving Lehman notes)
- New task forces at the SEC and at FINRA
- Focus by state securities regulators (for example, Georgia, New Jersey, New Hampshire, Utah)
- “Ongoing” compliance issues to watch out for in the area, including
  - Adequacy of disclosure
  - Relationships with distributors
  - Misselling/education and training
  - Note reopenings (“taps”)
  - Blackout issues/window cleaning
  - “Freezer” accounts

# Recent FINRA Guidance

## **FINRA Regulatory Notice 10-09: FINRA Reminds Firms of Their Sales Practice Obligations with Reverse Exchangeable Securities (Feb. 2010)\***

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- FINRA Regulatory Notice 10-09 focuses on three key areas:
  - Communications with the public regarding the promotion of reverse convertibles.
  - Review suitability before recommending purchase.
  - Supervision and training of a firm's registered representatives.

\*<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120920.pdf>

## FINRA Regulatory Notice 10-09: FINRA Reminds Firms of Their Sales Practice Obligations with Reverse Exchangeable Securities (Feb. 2010)

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- Communications with the public regarding the promotion of reverse convertibles:
  - FINRA recommends firm representatives discuss the product with the customer to ensure the customer is making an informed decision. Specifically, the representative should explain:
    - how the product works and its payout structure;
    - the fact that the principal value of the investment is not guaranteed and a customer may suffer a loss on its investment;
    - the effect of sales prior to maturity, and the fact that the potential resale price may depend on the existence of a secondary market; and
    - if the firm publishes its own research report regarding the reference asset, the representative should disclose the content of the research and how (and whether) the research is relevant to a purchase recommendation.

## FINRA Regulatory Notice 10-09: FINRA Reminds Firms of Their Sales Practice Obligations with Reverse Exchangeable Securities (Feb. 2010)

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- Communications with the public regarding the promotion of reverse convertibles (cont'd):
  - NASD Rule 2210: firms must ensure their communications with the public: are based on principles of fair dealing and good faith; are fair and balanced; and provide a sound basis for evaluating the facts about any particular security, industry or service.
  - Per NASD Rule 2210 firms cannot:
    - omit information if it would cause communication to be misleading, or
    - make false, exaggerated, unwarranted or misleading statements.
  - NASD Rule 2210 reminds firms that:
    - providing risk disclosure in a prospectus or supplement does not cure deficient disclosure in sales materials;
    - firm representatives should not suggest that reverse convertibles are ordinary debt securities; and
    - firms must not present annualized yield or coupon information for reverse convertibles in a misleading manner.

## FINRA Regulatory Notice 10-09: FINRA Reminds Firms of Their Sales Practice Obligations with Reverse Exchangeable Securities (Feb. 2010)

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- Review suitability before recommending purchase:
  - NASD Rule 2310: firms must have a reasonable basis for determining that a product is suitable for investors in general and suitable for each specific customer prior to recommending the purchase or sale of a security.
  - NASD Rule 2310 requires firms to make reasonable efforts to obtain information concerning:
    - the customer's financial status;
    - the customer's tax status;
    - the customer's investment objectives; and
    - any other information considered reasonable by the member or registered representative in making recommendations to the customer.
  - The NASD's IM 2310-2(e) stresses a firm's obligation to deal fairly with customers when making recommendations or accepting orders for new financial products by making sure the firm familiarizes itself "with each customer's financial situation, trading experience, and ability to meet the risks involved with such products."
  - Eligible Accounts: firms should consider whether the purchase of reverse convertibles should be restricted to investors whose accounts have been approved for options trading.

## FINRA Regulatory Notice 10-09: FINRA Reminds Firms of Their Sales Practice Obligations with Reverse Exchangeable Securities (Feb. 2010)

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- Supervision and training of a firm's registered representatives
  - Member firms are required to have written supervisory procedures and supervisory controls that are reasonably designed to ensure sales of reverse convertibles comply with federal securities laws and FINRA rules.
  - FINRA also requires firms to adequately train employees who sell, or supervise those who sell reverse convertibles. The training should focus on:
    - associated costs and risks of the product;
    - the terms and conditions of the product;
    - the reference stock, index or other asset;
    - the investment's potential for growth;
    - the product's liquidity before maturity; and
    - any other components that may impact suitability for general or specific customers.

## FINRA Regulatory Notice 10-09: FINRA Reminds Firms of Their Sales Practice Obligations with Reverse Exchangeable Securities (Feb. 2010)

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- Recent Developments

- FINRA announced that it had fined Ferris, Baker Watts LLC for inadequate supervision of sales of reverse convertible notes to retail customers. In its statement, FINRA noted that Ferris, Baker Watts had inadequate written procedures relating to sales of these products.
- Broker-dealers should continue to review their internal procedures relating to assessing suitability, as well as their procedures for assessing portfolio concentrations. The training of sales forces in connection with structured product sales also should remain a top priority.

## FINRA Regulatory Notice 09-73: FINRA Reminds Firms of Their Sales Practice Obligations Relating to Principal-Protected Notes (Dec. 2009)\*

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- FINRA Regulatory Notice 09-73 focuses on three key areas:
  - Ensure communications are fair and balanced and provide appropriate disclosures.
  - Conduct reasonable suitability assessments prior to recommending principal-protected notes to customers.
  - Train the firm's registered representatives.

\*<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120596.pdf>

## FINRA Regulatory Notice 10-09: FINRA Reminds Firms of Their Sales Practice Obligations Relating to Principal-Protected Notes (Dec. 2009)

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- Ensure communications are fair and balanced and provide appropriate risk disclosures
  - NASD Rule 2210
- Conduct reasonable suitability assessments prior to recommending principal-protected notes to customers
  - NASD Rule 2310
  - NASD IM 2310-2(e)
- Train Registered Representatives
  - Adequately train registered representatives regarding the terms, conditions, risks and rewards of these products

# FINRA Sweep

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- March 2011: FINRA announced a targeted examination into “Reverse Exchangeable Securities (Reverse Convertibles) Advertising and Sales Literature”
- As part of its review, FINRA requested advertisements, sales literature, and institutional sales materials, offering documents, etc.

## Recent Action by FINRA Relating to RevCons

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- April 2011, FINRA fined Santander Securities
- Issues raised by FINRA:
  - unsuitable sales
    - citing sales to retirees
  - inadequate supervision of structured products sales
    - citing a lack of training, a lack of suitability guidance
  - inadequate supervision of accounts funded with loans
  - concentrated positions in revcons
    - no detection or screening system

# Consent Agreement

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- Fine and restitution
- Related to losses suffered in connection with Lehman principal-protected notes
- Many of the issues raised by FINRA were the same issues raised by FINRA in its regulatory notices and notices to members
- Offering documents must not provide misleading information about the nature of principal protection
  - must have clear references to issuer credit risk
  - must make clear that product is not guaranteed
  - should note risk that investor may lose all of its investment upon an issuer's bankruptcy

# Consent Agreement

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- Attention must be paid to all communications
  - FINRA commented on monthly strategies guide, as well as on internal-use-only documents
  - Internal documents also must be fair and balanced
- Suitability assessments must be made – there should not be a presumption of suitability merely because a product provides for principal protection
- The broker-dealer should monitor the issuer's financial condition and communicate with investors regarding credit risk issues
- Supervision and training is essential
- References to CDS spreads may create confusion for market participants

# SEC/FINRA Investor Education Release

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- Use of “principal protection” in name may be confusing to investors
- There should not be any suggestion that products are risk-free – subject to issuer credit risk
- Limited secondary market

# FINRA Guidance on Know Your Customer and Suitability

# Recent Changes

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- FINRA has adopted changes to FINRA Rule 2090 (Know Your Customer) and Rule 2111 (Suitability)
- The rules now:
  - Apply suitability determinations to recommended investment strategies (not only to recommendations relating to specific securities)
  - Identify three components to suitability: reasonable basis suitability, customer specific suitability and quantitative suitability
  - Would include in quantitative suitability that the broker-dealer make an assessment that a series of transactions, if viewed together, are suitable for a client
- Rule expands the items to be considered as part of a retail investor's profile to include: age, other investments, financial situation and needs, tax status, investment objectives, investment experience, time horizon, liquidity needs and risk tolerance

# Recent Changes

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- Addresses how customer suitability obligation may be discharged for institutional accounts
  - Broker-dealer may discharge if it has a reasonable basis to believe that the institutional customer is capable of evaluating the investment risks independently and the customer affirmatively indicates that it is exercising independent judgment in evaluating the recommendation
- “Institutional account” is defined to include an institutional investor with \$50 million in assets under management

# Disclosures to Retail Investors

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- FINRA Regulatory Notice 10-54 solicits comments on a Concept Proposal to require that members at or before commencing a relationship with a retail customer provide a disclosure statement
- The disclosure statement would describe:
  - The types of accounts and services the broker-dealer provides,
  - The conflicts associated with those accounts and services, and
  - Any limitations on the dates that the firm owes to retail customers
- Fees and services: the statement would disclose fees for each type of service or account and whether fees are negotiable
- Financial incentives: the statement would disclose the incentives that a broker-dealer may have to recommend certain products over others, as well as the terms of any referral arrangement

# Disclosure Statement

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- Dodd-Frank Act Section 913 requires that the SEC “facilitate the provision of simple and clear disclosures to investors regarding the terms of the their relationships with [broker-dealers] and investment advisers, including any material conflicts of interest.”
- Section 919 of the Dodd-Frank Act authorizes the SEC to issue new rules designating disclosure documents or information to be provided by broker-dealers to retail investors before the sale of any investment product or service

# ERISA

# Proposed ERISA Regulations

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- October 21, 2010 DOL issued a proposed regulation that would expand the categories of persons considered fiduciaries as a result of their investment advice to ERISA plans or participants or beneficiaries of such plans
- Current regulation provides that a person is a fiduciary as a result of rendering investment advice to an ERISA plan, if the person:
  1. Renders advice as to the value of securities or makes recommendations as to the advisability of investing in, purchasing, or selling securities,
  2. On a regular basis,
  3. Pursuant to a mutual agreement or arrangement,
  4. That will serve as a primary basis for investment decisions with respect to plan assets, and
  5. That will be individualized based on the particular needs of the plan

# Proposed ERISA Regulations

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- Proposed regulation would expand significantly the categories of persons that would be considered fiduciaries as under the proposed regulation there is no requirement that advice be given on a regular basis nor that it serve as the primary basis for an investment decision

# Dodd-Frank Related Developments

- The effect of the Dodd-Frank Act on the structured products market
  - Significant aspects of Title VII
    - Lincoln swaps “push-out” provision
- Required studies and rulemakings
- Investor protection aspects of the Act