European Developments Affecting Structured Notes and Retail Products

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Today’s Topics

• Introduction
• Update of European developments:
  ➢ Prospectus Directive
  ➢ MiFID II / MiFIR
  ➢ PRIPs
  ➢ Funds regulation
• Relevant global initiatives
• Approaches in individual EEA jurisdictions
• Final thoughts
Introduction

• Structured notes are investments in the form of a transferable security that offer a return linked to a market measure
• Can be sold to either retail or wholesale investors
• Examples of market measures:
  ➢ indices
  ➢ closing price of underlying on a regulated exchange
  ➢ ETFs
  ➢ interest rates
  ➢ currencies
  ➢ commodity spot prices and commodity futures
  ➢ baskets of any of the above
• Most are sold as senior debt of the issuer
• Similar risk and reward profiles can also be obtained through UCITS funds, alternative investment funds, structured deposits and some life insurance products
Upside Features

• Most structured notes will include at least one of these features.
• Typically these features apply only at maturity.
• Examples:
  ➢ upside leverage (>100% participation rate)
  ➢ booster/step up.accelerated return
  ➢ accelerated redemption
  ➢ digital return
  ➢ upside leverage
  ➢ cap
  ➢ absolute return
Downside Features

• Notes will typically include one feature that affects the note’s payout if the level/price of the underlying asset declines.
• Examples:
  ➢ principal protection
  ➢ buffer
  ➢ barrier
  ➢ absolute return
Income Notes

• These notes provide investors with periodic payments

• Examples:
  ➢ fixed coupon
  ➢ floating coupon:
    • LIBOR
    • Constant Maturity Swap Rate
    • year-over-year Consumer Price Index
  ➢ contingent or partially contingent coupon
  ➢ range accrual notes
  ➢ curve steepeners
Automatic Redemption

• Certain types of notes include an automatic redemption feature, also referred to as an automatic call or mandatory exchange.

• Typically, automatic redemption will occur if the level/price of the underlying asset exceeds a pre-determined level/price on an observation date.

• Some automatically redeemable notes include an initial non-call period.

• Notes are typically redeemed for cash, but some are exchanged for shares of an underlying stock or ETFs, which is referred to as “physical settlement.”
Prospectus Directive - Overview

• Prior to 1 July 2012, the primary legislation governing prospectuses for securities issuances in the EU comprised:
  ➢ the Prospectus Directive (2003/71/EC) (the “PD”) and
  ➢ the Prospectus Regulation (809/2004)

• The PD sets out the requirements (in terms of both form and content) for issuers to produce a prospectus, with the Prospectus Regulation providing for more detailed prospectus contents requirements

• Some of the main objectives of the PD were (i) to create a harmonised regime for drawing up, approving and distributing prospectuses; and (ii) create a single EU wide definition of what constitutes an ‘offer to the public’ (thereby also determining the circumstances in which transactional exemptions for non-public offers should apply)
Prospectus Directive - Overview (cont.)

- PD has been amended by Directive 2010/73/EU (the “Amending Directive”) which came into force on 1 July 2012 and two Commission Delegated Regulations of 30 March 2012 and 4 June 2012

- PD sets out requirements in terms of both form and content for issuers to produce a prospectus. The Prospectus Regulation sets out detailed contents requirements
Prospective Directive - Exemptions

• **Qualified Investor** - definition of Qualified Investor has changed in order to align it with the professional client and eligible counterparty definitions in the Markets in Financial Instruments Directive

• **Private placement exemption** – the number of non-qualified investors to whom an offer can be made in any one member state has increased to 150

• **Minimum total consideration per denomination exemption** – has increased to €100,000

• **Types of securities exempted** – (i) securities offered in connection with mergers and divisions where an equivalent document has been created; (ii) dividends paid out to shareholders in the form of shares; and (iii) securities offered, allotted, or to be allotted to employees of the company

• Most exemptions not relevant in the context of a distribution of structured notes to retail investors
Prospectus Directive – Retail Cascades

• “Retail Cascade” refers to process where a security is sold to retail investors through a chain of one or more intermediaries
• Originally, Prospectus Directive required a prospectus in respect of each on-sale of securities
• Amending Directive clarified that financial intermediaries are under no obligation to create a new prospectus on the resale or final placement of securities provided that:
  ➢ there is available a valid PD compliant prospectus, approved no earlier than 12 months prior to the resale or placement; and
  ➢ the person responsible for creating the prospectus consents to its use by written agreement
• The June 2012 delegated regulation sets out two options for an issuer seeking to provide its consent:
  ➢ the issuer can provide consent to one or more specified financial intermediaries if known at the time that the prospectus is drawn up; or
  ➢ the issuer can provide consent to all financial intermediaries
Prospectus Directive - Retail Cascades (cont.)

• Annex XXX to the Prospectus Regulation sets out the nature of the consent for the use of a prospectus. The issuer must provide certain information including:
  ➢ express consent to use of the prospectus and an acceptance of responsibility for its contents in respect of subsequent sales
  ➢ the period for which consent is given and the offer period in which resales / placements by intermediaries can be made
  ➢ the member states in which intermediaries can rely on the prospectus
  ➢ any conditions to the consent
  ➢ notice to investors that in the event of an offer by a financial intermediary, that intermediary will provide information to investors on the terms and conditions of the offer at the time the offer is made

• For consent for specified intermediaries, the issuer must list their names / addresses and how information on new intermediaries in the future will be published

• For consent given to all financial intermediaries, there must be a notice, in bold, informing investors that any financial intermediary using the prospectus must state on its website that it is using the prospectus in accordance with the consent and the conditions thereto
Prospectus Directive - Contents (cont.)

- March 2012 delegated regulation provides that the base prospectus must contain information to enable investors to make an informed assessment of the financial position of the issuer, any guarantor and the rights attaching to the securities.

- Information to be included in base prospectus and final terms is categorised into:
  - **Category A** – items that must be included in full in the base prospectus and cannot be left in blank for later insertion in the final terms (e.g. risk factors, governing laws and issuer credit ratings).
  - **Category B** – items where the general principles must be included in the base prospectus and only details not known at the date of approval of the base prospectus can be left blank for insertion in the final terms.
  - **Category C** – items where the base prospectus can contain a reserved space for later insertion in the final terms, relating to information not known at the date of approval of the base prospectus.
Prospectus Directive – Contents (cont.)

- ESMA and the UK FSA published consultation papers in March and February 2013 respectively
- Information that can be included in final terms is much more restricted than has previously been the case:
  - base prospectus cannot be amended or supplemented by final terms other than for Category B and C items where permitted and other limited circumstances including additional voluntary information allowed by Annex XXI to the Prospectus Regulation
  - where permitted under Categories B and C, base prospectus can contain options for specific provisions with the final terms specifying which options apply to the particular issuance
  - guidance notes in italicised text or disclosure obligations under other EU regulations are not now permitted to be included
  - no replication of information in base prospectus other than items consisting of different options relating to a security
  - payment formulae for structured securities can be included in a base prospectus algebraically, provided the prospectus can explain how the return on an investment occurs in understandable and comprehensible language. Final terms can then include the formulae with issuance specific details
  - for retail bonds, yield information must be included
Prospectus Directive - Summary

• Prospectus summary requirements were substantially amended by the Amending Directive:
  ➢ as previously, a prospectus summary is always required except in relation to non-equity securities with a denomination of at least €100,000
  ➢ must provide “key information” to investors in a concise manner and using non-technical language
  ➢ “key information” is defined as information which is essential to enable investors to understand the securities to which the prospectus relates
  ➢ summary must be in the order / format prescribed under Annex XXII of the Prospectus Regulation
  ➢ must be no longer than 7% of the prospectus or 15 pages (whichever is greater)
  ➢ must not cross-reference other parts of the prospectus

• Amending Directive also provides that an issue-specific summary must accompany any final terms for securities with a denomination of less than €100,000
Prospectus Directive – Summary (cont.)

• FSA consultative document clarifies that the issuance specific summary should not be included as a separate section in the base prospectus but should be attached to the final terms relating to the specific issuance

• The individual issuance summary must contain:
  ➢ information from the base prospectus summary which is only relevant to that issuance;
  ➢ the options from the base prospectus which are only relevant to that issuance; and
  ➢ the relevant information contained in the final terms for the issuance that has been left blank in the base prospectus
Prospectus Directive – Summary (cont.)

- Market concerns raised in relation to liability in respect of risk factors:
  - PD requires that ‘all material risks’ be disclosed in the risk factor section of the base prospectus
  - in relation to the prospectus summary, the PD Regulation requires only that key information on the key risks to the issuer be provided in the summary
  - some issuers have expressed concern that failure to highlight certain risks as key could give rise to potential liability and therefore include all risk factors as key risks
- FSA consultation paper rejects this practice:
  - FSA states it is not acceptable to include non-key risks in the summary
  - FSA suggest language to be included in risk factor section of base prospectus to make it clear all risk factors should be considered by investors but that the risks highlighted in the summary are those the directors consider are the most essential for the investor to consider in determining whether to invest in the securities
Prospectus Directive – Supplements

• Article 16 of the Prospectus Directive provides that any new significant factor, material mistake or inaccuracy relating to the information included in the prospectus which is capable of affecting an investor’s assessment of the securities must be included in a supplement to the base prospectus (subject to competent authority approval) or a new prospectus.

• Both ESMA and the FSA consultations consider issue of supplementary prospectuses (“SP”) required under Article 16 of the PD:
  - FSA do not consider it appropriate to use a SP for the purpose of clarifying or revising non-material drafting in the base prospectus.
  - FSA believe terms and conditions should generally not be altered through a SP nor should new features be added to a base prospectus through a SP. A new prospectus should be produced in these cases.
  - FSA states a SP may be used when making amendments to the period or amount of the original offer.
Prospectus Directive – Supplements (cont.)

- ESMA consultation paper sets out draft regulatory standards to establish the minimum situations where a supplement is required including:
  - publication of new audited financial statements
  - change of control of the issuer
  - publication of profit estimate for an annual financial period
  - a new significant financial commitment is undertaken which is likely to result in a significant gross change for securities
  - an increase in the nominal value of the programme
Prospectus Directive - Liability

- Under the PD, the issuer and its directors, the offeror, any person requesting admission to trading or the guarantor can be held liable for the contents of the prospectus:
  - provisions for liability are determined by individual member states
  - no civil or criminal liability can be attached to any party solely on the basis of the summary, unless it is inaccurate or misleading or inconsistent, when read with other parts of the prospectus, or it does not provide, when read with other parts of the prospectus, key information to aid investors when considering whether to invest
- In June 2013, ESMA published a report comparing liability regimes applied by EEA member states. Key findings include:
  - vast majority of member states indicate specific persons subject to civil and administrative liability and the majority take a similar approach in relation to the degree of fault needed to trigger liability – usually some form of negligence is required
  - the majority of member states do not specify the persons who could be subject to criminal liability and the degree of fault needed for criminal liability diverges significantly between member states
  - most member states apply fines and / or imprisonment for criminal liability whereas fines and other measures are usually applied for civil liability – the range of fines varies significantly between member states
• Markets in Financial Instruments Directive (MiFID) came into force in November 2007
• Provides pan-European regime for authorisation and supervision of financial institutions and financial services
• National regulators retain power to authorise and supervise financial institutions the established in their jurisdiction
• “Passport” regime introduced, so firms authorised in one EEA jurisdiction can provide financial services in other EEA Jurisdictions without the need for additional authorisations
• Requires firms providing financial services to customers, including financial advice and arranging sale of financial products, to categorise customer by type and, depending on categorisation of client and type of service provided, carry out appropriateness or suitability assessments on the customer
• Review always envisaged but onset of financial crisis has led to a more radical change than was originally envisaged
MiFID II / MiFIR - Overview

• MiFID II is an overhaul of MiFID comprising:
  ➢ draft regulation (MiFIR)
  ➢ recast directive (MiFID II)

• Initial legislative proposals published in October 2011 by EU Commission:
  ➢ various compromise proposals subsequently published
  ➢ on-going trialogue between EU Commission, Council of Ministers and Parliament
  ➢ EU Parliament plenary session now set for 9 to 12 December 2013

• MiFID II / MiFIR makes fundamental changes to MiFID including:
  ➢ greater emphasis on investor protection (less choice)
  ➢ increased regulatory capture for products and entities
  ➢ more intrusive regulation of products and entities
  ➢ major extension of transparency rules including to debt and structured products
  ➢ focus on enforcement and supervision
Provisions having particular relevance for structured notes and other retail products include:

- investor protection provisions (including execution-only exemption)
- market infrastructure reforms including new definition of organised trading facility (OTF)
- requirements for exchange trading of certain derivatives
- requirements for open access to trading venues
- extension of pre- and post-trade transparency rules to structured products and derivatives traded on a trading venue
- extensive provisions giving ESMA and competent authorities product intervention powers
- the provision of financial services in the EU by non-EU firms
MiFID II / MiFIR – Investor Protection

• Investor protection:
  ➢ some narrowing of client categorisations
  ➢ prohibition on firms providing independent investment advice or portfolio management from receiving third party inducements
  ➢ best-execution rules enhanced
  ➢ execution-only exemption retained (enabling non-advisory execution-only services to be provided to customers with no suitability or appropriateness assessment) but narrowed so structured UCITS are now outside exemption together with bonds or other forms of securitised debt that embed a derivative or incorporate a structure which makes it difficult to understand the risks involved
MiFID II / MiFIR - OTFs

- Definition of Organised Trading Facility (OTF);
  - will cover multilateral systems operated by an investment firm or market operator which enable multiple third parties to buy and sell financial instruments under the scope of MiFID
  - will catch wide range of trading venues including both voice and electronic trading and broker-crossing systems
  - not designed to include pure OTC transactions

- Regulation of OTFs:
  - to be subject to MiFID authorisation and conduct of business rules including best-execution
  - client orders in OTF not permitted to be executed against proprietary capital of OTF operator (but matched principal trading permitted for debt instruments – not derivatives subject to the clearing obligations)
  - scope of OTFs remains an outstanding issue
MiFID II / MiFIR – Exchange Trading of OTC Derivatives

• Exchange Trading of OTC derivatives:
   MiFIR provides that all derivatives subject to a clearing obligation under EMIR and determined to be subject to a trading obligation under EMIR should be traded on a regulated market, MTF or OTF or third country venue meeting equivalence and other requirements
   ESMA to develop technical standards (and consult) in relation to classes of derivatives to be subject to the trading obligation
   ESMA must consider the class to be “sufficiently liquid” taking into account factors such as average frequency, average size and number of trades, average size of spreads and profile of market participants
MiFID II / MiFIR – Competitive Access

• Competitive access for trading venues:
  ➢ current draft of MiFIR provides that trading venues must provide open access on a non-discriminatory and transparent basis including provision of trade feeds to CCPs
  ➢ CCPs required to accept financial instruments cleared by it on a non-discriminatory and transparent basis regardless of trading venue on which trade is executed
  ➢ proposals controversial in many jurisdictions and issue remains one of most significant outstanding issues in MiFID II / MiFIR negotiations
  ➢ current EU Council compromise proposal recommends a review that will assess delaying open access for up to three years
MiFID II / MiFIR – Transparency

• Pre- and post-trade transparency for derivatives and structured products:
  ➢ EU Commission believes the same pre- and post-trade transparency requirements should apply to regulated markets, MTFs and OTFs
  ➢ calibration for different types of instrument and trading
  ➢ MiFID already provides for transparency requirements for shares traded on a regulated market
  ➢ MiFIR will extend regime including to bonds, structured finance instruments and derivatives traded on a trading venue
  ➢ obligation to make publicly available current bid and offer prices and depth of trading interest
  ➢ rules to make public firm quote to apply to systematic internalisers where there is a liquid market and they agree, following a client request, to provide a quote
  ➢ competent authorities will have powers to grant waivers from requirements – ESMA to be notified of waivers and will give opinion as to compatibility of waiver with MiFIR
  ➢ competent authority can suspend pre-trade transparency requirements if liquidity falls below a specified threshold – ESMA to be notified
MiFID II / MiFIR – Product Intervention

- Product intervention powers to be granted to ESMA and competent authorities

- Latest Council compromise proposal for MiFIR provides that ESMA can take action to temporarily prohibit or restrict marketing, distribution or sale of certain financial instruments or financial instruments with certain features if addressing a threat to:
  - investor protection OR
  - the orderly functioning and integrity of financial markets OR
  - the stability of all or part of the EU financial system AND
  - existing regulatory obligations do not address the relevant threat and the relevant competent authorities have not taken appropriate action to deal with the threat

- ESMA must take into account possible detrimental effect on the efficiency of markets and potential for regulatory arbitrage

- ESMA must give prior notification to competent authorities and publish details on its website
• Competent Authorities will also have power to restrict marketing or sale of financial instruments on the same grounds as ESMA

• Action must be proportionate taking into account:
   nature of risks identified
   level of sophistication of investors or market participants
   likely effect of action on investors or market participants

• Authority must consult with other authorities likely to be affected by such action

• Action must not have a discriminatory effect on services or activities provided from another member state

• At least one month’s notice must be given and details published on authority’s website

• ESMA must seek to coordinate action taken by competent authorities
MiFID II / MiFIR – non-EEA Firms

• MiFIR and MiFID II propose harmonised framework for granting access to EU markets for firms based outside the EU
• Original MiFID II draft provides any provision of services to retail clients by a non-EU firm must be through an EU branch:
  ➢ firm will need to be authorised in member state where branch is located
  ➢ branch will be subject to certain MiFID rules including cob rules, organisational requirements and conflicts of interest
  ➢ firm must be located in a jurisdiction where EU Commission has determined legal and supervisory requirements are equivalent to MiFIR / MiFID / CRD IV
  ➢ other conditions must be satisfied including provisions for reciprocal recognition and cooperation requirements
  ➢ once branch is authorised it can conduct business across EU without further authorisation
• Firms outside EU would be permitted to provide services to eligible counterparties in EU without establishing a branch if registered by ESMA and EU Commission makes equivalence determination in relation to its home member state
MiFID II / MiFIR – non-EEA Firms (cont.)

- Proposals relating to access for non-EU firms heavily criticised – likely to affect ability of non-EU firms to operate in EU and could give rise to reciprocal provisions
- Latest EU Council compromise proposal provides:
  - third country firms providing investment services through a branch in a member state shall be subject to authorisation and supervision in that member state
  - cooperation arrangements to be in place between host member state and home jurisdiction (ESMA to develop technical standards)
  - branch should have sufficient initial capital
  - host member state and home jurisdiction must have signed an agreement equivalent to OECD Model Tax Convention
  - provision by third country firm of investment services or activities to retail clients must be done through a branch
  - no provisions re passporting by third country firms
  - no new requirements for professional markets
PRIPs - Overview

• Initiative dates back to ECOFIN request to EU Commission in 2007
• Aim to seek greater consistency and more level playing field in regulation across different investment products in the EEA including structured notes
• Increased focus on investor protection following financial crisis
• Various consultations have been published focusing on:
  ➢ definition of “PRIPs”
  ➢ product disclosure
  ➢ point of sale regulation
• Point of sale issues now largely dealt with in MiFID II / Insurance Mediation Directive
• Draft regulation published on 3 July 2012:
  ➢ subsequent compromise proposals
  ➢ ECON committee proposed amendments on 22 October 2013
  ➢ EU Parliament has now approved ECON proposal in plenary session
• Regulation applies to “investment products”, being
  “an investment where regardless of the legal form of the investment the amount repayable to the
  investor is exposed to fluctuations in reference values or in the performance of one or more
  assets which are not directly purchased by the investor”

• Certain categories of product are expressly excluded:
  ➢ deposits with a rate of return determined by reference to an interest rate
  ➢ “vanilla” securities not embedding a derivative
  ➢ insurance products where surrender value is not exposed to fluctuation in underlying
    assets or reference values
  ➢ many occupational pension schemes

• Scope of definition largely unchanged in compromise drafts

• European Parliament has, however, indicated a desire to extend
  scope of PRIPs regulation to wider class of retail products:
  ➢ ECON Committee has agreed to exclude from the scope of the regulation, deposits,
    securities issued by credit institutions not embedding a derivative and insurance policies
    which do not offer a surrender value. Its proposed definition of PRIPs is however, much
    wider than packaged products and include all financial securities other than those
    exempted
Draft regulation provides that where an investment product is to be sold to retail investors a Key Information Document (“KID”) must be prepared.

Primary responsibility to draw up KID is on the ‘investment product manufacturer’.

KID requirements as to form and content are detailed:

- intended to create standardised format of KID to aid comparability across different types of product
- stand-alone document separate from any marketing materials
- to be clearly titled “Key Information Document”
- drawn-up in one of the official languages of the member state where the product is being sold
- KID should be “short” but no specific length limit
- to be provided in hard-copy or on website
- over-arching requirement to be “fair, clear and not misleading” and for language to be “clear, succinct and comprehensible” supplemented by detailed content requirements with mandatory headings in a specified order
PRIPs – KID (cont.)

- EU Council comprise proposal suggests various amendments relating to the KID:
  - move away from requirement of KID to be “standalone” document – indicates the KID should “help” in investor decision making and stresses need for investors to seek advice re suitability
  - specific limit of 3 pages for the KID
  - deletes exemption for “other securities that do not embed a derivative” – potentially widens scope of products coming under the regulation
PRIPs – KID (cont.)

• ECON Committee of EU Parliament proposes fundamental amendments relating to the draft regulation including:
  ➢ establishment of product approval process by product manufacturer
  ➢ requirement for seller of product to complete an annex containing details of the seller including relevance of tax regime where the seller sells or advises in respect of the product
  ➢ KID to be limited to two pages plus the annex
  ➢ seller of product to be responsible for the annex
  ➢ online ‘fund calculator’ to be developed by ESAs enabling investors to compute reward of a proposed investment product – data to be provided by product manufacturers and distributors
  ➢ ‘complexity label’ to be added to certain products including where the risk/reward profile or costs are presented ‘in an overly complicated manner’ or where the product invests in assets not commonly invested in by non-professional investors (ESAs to develop guidelines)

• ECON proposals adopted by EU Parliament on 20 November 2013 and “trialogue” with Commission and Council will now commence
PRIPs – Liability

• Liability and sanctions provisions:
  - draft regulation provides that where a retail investor can demonstrate a loss resulting from its reliance on information in the KID, the burden of proof is on the product manufacturer to show the KID is in compliance with the regulation
  - reversal of burden of proof has been criticised by market participants
  - need for a coherent liability regime consistent with other regulatory requirements including Prospectus Directive and UCITs has been stressed by market participants
  - Council compromise proposal provides that a person shall not incur civil liability on the basis of the KID unless it is misleading, inaccurate or inconsistent with the other binding contractual documents
  - issue of liability likely to be a key issue during ‘trialogue’
  - draft regulation requires member states to set down sanctions for breaches of the regulation including possible suspension of marketing of a product or public warning
  - the ECON proposals maintain the reversal of the burden of proof and extend liability provisions to the distributor in relation to the annex. It also seeks a more extensive approach to sanctions which will apply to any breach of the regulation, delete certain exemptions in the draft regulation and set out specific provisions for fines of up to 10% of the product manufacturer’s total annual turnover for individuals
ECON Committee have also proposed significant extensions to the scope of the draft regulation including:

- specific intervention powers to be given to the ESAs and national competent authorities including investigation of new products or instruments and the ability to restrict marketing, distribution or sale of products where it believes there is a threat to retail investor protection or to the orderly functioning and integrity of financial markets or EU financial stability
- requirement for product manager to employ a risk-management process which enables it to monitor and measure the risk profile of the investment product at any time
- rules relating to the pay-off of a product which cannot (a) include a number of mechanisms, events or asset classes creating a risk of misinterpretation, (b) be conditional upon the occurrence of events uncommon for retail investors including regulatory capital levels or (c) include packaging features “playing on the behavioural biases of retail investors”
Funds Regulation

- Funds regulation in EU distinguishes between UCITS funds (principally used for retail investors) and alternative investment funds
- Both now subject to pan-European regulation with UCITS Directive for UCITS funds and AIFMD for alternative investment funds
  - UCITS directive originally adopted in 1985 and has evolved substantially since then, with further directives referred to as UCITS II, UCITS III and UCITS IV being subsequently adopted
  - UCITS disclosure now required in a key investor information document or “KIID” on which the proposed PRIPs KID is closely modelled
  - in July 2012, the EU Commission published a legislative proposal for UCITS V, making amendments to UCITS IV in respect of the depositary function, remuneration and sanctions
  - in July 2012, the EU Commission published a further consultation paper to determine whether further changes to the UCITS regime are required under a new UCITS VI. The issues considered in the paper include portfolio management, liquidity management, money market funds and long-term investments
  - AIFMD became effective in July 2013
Global Initiatives

- A number of papers have been published in relation to the regulation and distribution of structured products. The principal ones are highlighted below.

- IOSCO final report on suitability requirements with respect to the distribution of complex financial products, January 2013
  - nine key principles in relation to distribution of complex financial products
  - definition of complex product does not seek to be exhaustive but includes any product whose terms, features and risks are not likely to be understood by a retail customer because of their complex structure (including credit and equity-linked notes and ABS/MBS)
  - principles focus on understanding of product by intermediaries, advice, understanding of customer’s categorisation, financial sophistication, risk appetite and ability to absorb losses but does not seek to impose rigid rules on products that may or may not be sold to retail customers
Global Initiatives (cont.)

- IOSCO April 2013 consultation report on regulation of retail structured products:
  - provides feedback on work done by its working group on retail structured products
  - notes many jurisdictions have engaged in recent regulatory and policy action in relation to structured products and most have product intervention powers of some kind
  - 2013 report does not propose specific regulatory action by IOSCO members but sets out a “regulatory toolkit” of items members may consider in their regulation of retail structured products including:
    - measures to reduce regulatory arbitrage opportunities
    - addressing whole life-cycle of product, not just point of sale
    - robust disclosure structures including short form or summary disclosure
Global Initiatives (cont.)

- ESMA economic report on ‘retailisation in the EU’ published on 3 July 2013 focuses on the sale of complex products to retail investors (which it refers to as “retailisation”) including structured notes

- Issues highlighted by ESMA in relation to such products include:
  - strategies implemented by alternative UCITS may not be easy to determine and may be challenging for retail investors
  - volatility of returns on alternative UCITS was high between 2006 and 2012, particularly at height of financial crisis during 2007 and 2008 (but generally lower than non-UCITS hedge funds)
  - risk and reward profile is not straightforward and requires substantial financial expertise and access to market data
  - many retail investors may not possess the expertise needed to assess the drivers of the performance of such products and could be at risk of facing unexpected losses
  - the analysis of the issuer credit risk embedded in structured products may be particularly challenging
  - given the difficulties investors may face in understanding structured products, it is important to ensure appropriate information on the characteristics of the product is provided to retail investors
Global Initiatives (cont.)

- BCBS/IAIS/IOSCO Joint Forum paper on point of sale disclosure in the insurance, banking and securities sectors in July 2013
- Paper seeks to identify differences and gaps in regulatory approaches to point of sale disclosure in relation to investment or savings products in the insurance, banking and securities sectors:
  - similarities to PRIIPS initiative in EU
- Joint Forum identified key sectoral and inter-jurisdictional differences in point of sale ("POS") disclosure requirements and sets out eight recommendations, including:
  - jurisdictions should consider requiring a concise written or electronic POS disclosure document
  - POS document should be provided free of charge to consumers prior to purchase
  - document should be clear, fair, not misleading and written in plain language
  - POS disclosure should be consistent in information provided to facilitate comparison of competing products
  - clear allocation of responsibility for preparing, making available and distributing the POS as between product manufacture and distributor
- Responses to paper note there is considerable overlap with EU PRIIPS proposal
Approaches in Individual EEA Jurisdictions

• Although there has been a lot of work as highlighted above in establishing international principles for the manufacture, marketing, sale and distribution of structured products to retail investors (particularly complex products) there have been many developments by individual jurisdictions.

• Approach to regulation varies widely across different jurisdictions due to many factors including:
  ➢ differing needs and financial sophistication of investors
  ➢ investors’ familiarity with specific wrappers in different jurisdictions
  ➢ taxation issues (no co-ordinated approach in EU)
  ➢ differences in rules relating to investment advertisements (no co-ordinated approach in EU)
  ➢ differences in distribution mechanism in different jurisdictions

• Below is a very high-level summary of recent developments in some selected EEA jurisdictions.
Approaches in Individual EEA Jurisdictions (cont.)

United Kingdom

• FSA (now superseded by the FCA) implemented Retail Distribution Review (RDR) from 1 January 2013 covering a range of measures designed to increase trust and confidence of retail investors:
  ➢ firms to state whether they offer ‘independent’ or ‘restricted’ advice
  ➢ ban on commission for advised sales relating to investment products
  ➢ FSA/FCA have sought to ensure compatibility of the RDR with relevant EU legislation, including MiFID

• FSA/FCA have published various papers on product intervention, most recently FSA Consultation Paper 12/35 on “Use of Temporary Product Intervention Rules” indicating a more interventionist and ‘through the cycle’ approach to product regulation

• Financial Services Act 2012 gives the FCA powers to introduce temporary product intervention measures including barring or restricting sales of certain products or services
France

• On 15 October 2010, the AMF issued rules on the marketing of complex financial products, including obligations in relation to pre-contractual disclosure, suitability and appropriateness assessments of clients and issues designed to reduce mis-selling of products:
  - additional requirements for complex products including disclosure that product is defined as too complex by AMF to be marketed to retail investors
  - effectively prevents sale of complex products to retail investors
  - complexity judged by four criteria including a product ‘an investor is not familiar with’ (AMF state this applies where the reference assets cannot be valued by the investor during its life) or where the pay-out features more than three mechanisms

• Marketing communications must be submitted to the regulator prior to distribution to public to check compliance with certain rules

• The outcome of structured funds are required to be guaranteed by an external guarantor
Approaches in Individual EEA Jurisdictions (cont.)

Belgium
• In 2011 the FSMA declared a voluntary moratorium on the distribution of ‘particularly complex’ structured products
  ➢ subsequent public consultation on the moratorium and development of new regulatory framework for the distribution of structured products to retail investors
  ➢ FSMA sets out four criteria for determining what constitutes a particularly complex product - includes where the value of the underlying is not easily accessible or where the calculation formula comprises more than three mechanisms
  ➢ applies to all structured products irrespective of the wrapper
• It is compulsory to submit marketing communications to the regulator prior to distribution to the public to check compliance with minimum requirements

Germany
• Germany already has a requirement for a summary document, similar to the proposed PRIPs KID to be provided to investors prior to sale for a range of investments including retail structured products
• No regulatory pre-approval process but compliance officer of issuer must be incorporated into new product approval process to ensure compliance with the code of conduct rules
Approaches in Individual EEA Jurisdictions (cont.)

Italy

• Guidelines on distribution of illiquid financial products have been published by CONSOB with various recommendations including:
  ➢ specific requirements to be complied with in relation to product engineering, identification of target markets and internal processes to price such products
  ➢ how MiFID provisions should apply to the distribution of illiquid financial products
  ➢ provisions seeking to improve comparability of different products through pre-contractual disclosure

• Public consultation launched on the regulatory framework for retail structured products

• To seek to limit regulatory and product arbitrage and enhance investor protection to complex products, prospectus requirements have been extended to any offer of financial products to the public
Final Thoughts

• Is structured note regulation global or regional?
  ➢ are we moving towards a co-ordinated global approach to regulation of structured notes and other retail products or will we see continued balkanisation of regulation?
  ➢ as demonstrated above, individual jurisdictions take very different approaches to regulation making cross-border offerings of structured notes extremely challenging

• Is there a move away from complexity?

• Will we see more exchange trading of products?

• Does greater transparency provide a solution?