

Structured Thoughts

News for the financial services community.



It's Complicated: A Recap of SIFMA's Complex Products Conference

On September 27, 2012, SIFMA hosted a conference on Complex Products. The day-long session covered "complex products" and included various presentations about structured products and exchange-traded products. Many materials from the session are available on the SIFMA site, at <http://www.sifma.org/cpf2012/highlights/>.

The program began with a presentation by FINRA head Richard Ketchum, who addressed the growth in sales of complex products offered to retail investors. Consistent with various recent FINRA pronouncements, in his remarks Ketchum indicated that FINRA was following closely the initiatives undertaken by foreign regulators as to complex products. Specifically, Ketchum noted that while we rely on a disclosure-based, and not a merit-based, approach, in recent years, foreign regulators have implemented merit-based assessments of complex products, which have resulted in certain products being prohibited for retail distribution. Ketchum noted that "If the industry and regulators are unable to demonstrate their ability to control sales practice abuses relating to complex products through appropriate supervisory controls and oversight, then some forms of product approval may become inevitable."

Ketchum did not offer up a definition of a "complex product" but volunteered that a product might be complex if the average retail investor likely would not understand the performance of the product under different circumstances or the risk and return profile. Range accruals, "worst-of" and dual directional products were singled out. Leverage also was flagged as a concern.

Ketchum focused on the product life cycle, from vetting of the product at inception by a new product committee, consideration of cost, conflicts, etc., to training. Also, he noted that there may be limitations that firms should put in place to restrict the distribution of certain products to retail investors. Ketchum also suggested that firms should consider whether there were any special incentives or fee structures in place that would cause a broker to recommend a complex product over other products. Again, looking to Europe, he referenced a recent Martin Wheatley (FSA) speech on sales of structured products (you can see here: <http://www.fsa.gov.uk/library/communication/speeches/2012/0905-mw.shtml>). Ketchum concluded by reminding firms that sales of complex products to discretionary accounts were particularly concerning, and, that in all cases, customers should understand and have explained to them product features.

A mid-morning panel addressed legal and regulatory developments. William Hayden, Senior Director, Emerging Regulatory Affairs, FINRA, addressed many of the lingering questions relating to FINRA's Notice to Members on Complex Products. Hayden reiterated a number of points made in the Notice and observed that the Notice should be viewed as a restatement of FINRA's prior guidance in the area. Hayden explained that FINRA was reluctant to provide bright line tests for "complexity" given that any specific tests might become stale and fail to address product innovations. Moreover, Hayden noted that a product that was once complex might become so familiar and its features so well-understood that it might not always be considered a "complex product." In response to a question, he tried to draw some distinctions between the responsibilities of a product manufacturer and the distributor that directly interacted with the retail consumer. He discussed the need for robust training, including training of distributors, and the need to conduct thorough diligence on distributors. Other panelists also noted the importance of robust know-your-distributor policies. Hayden also addressed briefly the additional guidance given in 12-25 relating to suitability. Marc Minor, Chief, Investor Protection Bureau of the New York Office of the Attorney General, provided a perspective regarding the efforts of state securities regulators relating to complex products. Minor explained that NASAA has actively been following developments relating to structured products and has established a task force on structured products. Minor noted that there have been a significant number of customer complaints related to structured products. The state regulators are focused on sales of overly complex products, sales of products to at-risk investors, including seniors, and the misselling of structured products. Reid Muoio also joined the panel to explain the mission of the Structured and New Products Unit of the Division of Enforcement of the Securities and Exchange Commission. To date, most of the Unit's work has been focused on mortgage products, including CDOs. He discussed a few of the Unit's enforcement matters. Muoio also discussed the work of the Unit—collaborating with other groups within the SEC also focused on the area in order to learn more about structured products. He noted that, to date, most of the actions that had been brought by the Unit were based on disclosure claims. Muoio commented a fair bit on the disclosures relating to certain structured products.

During the lunch session, Susan Axelrod of FINRA Member Regulation and Sales Practices addressed FINRA's concerns regarding non-traded REITs and reverse convertibles. Axelrod emphasized that many investors seem to be attracted to these products in an effort to benefit from higher-yielding products, but do not understand the associated risks. She discussed a number of findings from prior FINRA actions, including failure to monitor concentration, failure to ensure the adequacy of supervisory systems, and failure to train. She addressed FINRA's recently announced sweep regarding the types of policies firms have adopted to identify, manage and mitigate conflicts of interest. See our prior alert on conflicts here: <http://www.mofo.com/files/Uploads/Images/120814-FINRA-Conflicts-of-Interest.pdf>. Specifically, in this regard, she noted that FINRA was taking a look at the conflicts arising in the structuring of products created by affiliates and in the compensation arrangements with "product manufacturers." She advised that firms should have written policies to address how these conflicts are managed and disclosed.

Axelrod closed by emphasizing the importance of product vetting, due diligence related to the issuer and the features of any new product, assessment of the sufficiency of a firm's supervisory procedures and systems to address issues posed by new products, guidelines for discharging the suitability obligation, and firm training. She noted that the more effective procedures FINRA has reviewed establish customer eligibility requirements for complex products, and establish procedures to monitor concentrations.

All in all, the conference presented a range of views regarding exchange-traded products and structured products, and the discussions by regulators made clear that complex products are a continuing area of focus. Also, it is clear

that regulators in the United States are following closely the actions taken in Europe and in Asia in similar areas. We will have a more detailed report in our next issue of this newsletter.

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Morrison & Foerster named [Structured Products Firm of the Year, Americas](#), 2012 by *Structured Products* magazine for the fifth time in the last seven years. See the write up at <http://www.mofo.com/files/Uploads/Images/120530-Americas-Awards.pdf>.

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