Keep it simple

Supervisors have taken an increasing interest in structured products recently. But regulating complexity isn't easy

Structured products have come under considerably greater regulatory scrutiny in recent years. In the US, regulators have become increasingly interested in structured products as the market for these products has grown to approximately $64 billion in 2012. Although structured products are relatively new to the US market, they have a long history in Europe, where the market, despite recent volume declines, remains deeper and more varied than in the US.

Investors on both shores have sought out these products for their higher yields and tailored return profiles, which provide portfolio diversification. These products are designed to meet the needs of investors and offer distinct benefits that cannot otherwise be easily obtained. However, regulators have expressed concerns that many investors who purchase these products may not fully understand their risk profiles or their costs relative to benefits, and that the products may be too complex for retail investors.

Concerns have also been voiced that investors focus principally on yield and not sufficiently on the potential risks associated with particular pay-off profiles. Finally, the financial crisis has engendered heightened suspicion among regulators as to any product that entails financial engineering. A complex product is viewed with some scepticism, and the features that may not be well understood may be perceived to obscure embedded fees or risk of loss of principal. As discussed below, US regulators are keenly focused on European regulatory initiatives in this area.

These European regulatory initiatives have included attempts to: catalogue or label complex or non-mainstream products; regulate products packaged in distinctly different formats as close substitutes; establish product development guidelines for structured products; identify suitability requirements specific to complex products; and introduce product intervention efforts.

The results of these efforts to date have contributed to improved market practices, but also suggest that a financial crisis should not be the catalyst for moving away from disclosure-based regulation and regulation of broker-dealer sales practices in favour of merit-based assessments.

> **"Financial products bearing very different characteristics are often lumped together"**

Defining complex products

Financial products bearing very different characteristics are often lumped together and referred to as structured products if the products entail any structuring. Articles often discuss structured credit products, like collateralised debt obligations (CDOs) or collateralised loan obligations (CLOs), in the same sentence as market-linked fixed income securities. This undifferentiated approach has led to a fair bit of confusion. Structured products or market linked investments, which are debt securities with cash flow characteristics that depend on the performance of one or more reference assets, are often grouped into the complex product bucket.

In Europe, the International Organisation of Securities Commissions (Iosco) and certain national regulators (particularly the Belgian *Autoriteit voor Financiële Diensten en Markten* and French *Autorité des Marchés Financiers*) have sought to define complex or non-mainstream products. The Iosco principles on suitability requirements for the distribution of complex financial products define a complex financial product as a financial product the terms of which are not likely to be understood by an average retail investor, where the product has a complex structure, is difficult to value without specific skills/systems, and/or has a very limited or no secondary market and is therefore potentially illiquid. This is a bit circular, in the sense that a product will be termed complex based on the subsequently established lack of understanding of a prototypical retail investor.

Similarly, under the Belgian standard the accessibility and transparency of an instrument's underlying value is a factor in determining whether it is 'particularly complex', but also whether the instrument's strategy is 'overly complex'. This includes the use of teaser rates, leveraged downside and conditional principal protection and whether the payout calculation requires more than three mechanisms.

The US has not yet formulated a definition. In January 2012, the Financial Industry Regulatory Authority (Finra) released Regulatory Notice 12-03 entitled 'Complex Products: Heightened Supervision of Complex Products'. The notice specifically references European regulatory initiatives that have as their objective imposing heightened requirements in relation to the sale of complex financial products. Instead of attempting to provide a definition of a complex product, the notice identifies the types of products that may be considered complex and provides guidance to member firms regarding supervisory concerns associated with complex product sales.

The notice states that 'any product with multiple features that affect its investment returns differently under various scenarios is potentially complex'. Products that include complicated or intricate derivative-like features, such as a wide variety of structured notes, certain exchange-traded funds, hedge funds and asset-backed securities, are identified as complex. Although the notice relies largely on the use of examples to illustrate complexity, like European efforts it also identifies the likely lack of understanding of an average retail investor as a possible characteristic indicating complexity.

It is worth noting that regulators have tended to focus on the inclusion in a financial instrument of features or interdependencies that may affect returns as a substitute for riskiness. One wonders whether an investment in the ordinary shares of a technology company or a drug discovery company might require a retail investor to make more sophisticated assessments than those required in connection with a principal-protected note. One might also reasonably ask whether labeling of a product as non-mainstream serves a constructive purpose. Although investment professionals may not shy away from so-called alternative investments and might instead recognise the importance in portfolio construction of diversification and access to reference assets, such as commodities or currencies, the average retail investor is likely to be deterred by pejorative labels.

Heightened obligations for sales of complex products

One of the principal purposes of recent efforts to identify complex products is to impose stricter standards with respect to the sales of these products to retail investors. At least in the US, registered broker-dealers have an obligation to establish new product approval procedures, product diligence requirements, and know-your-customer and suitability obligations. Registered investment advisers have a fiduciary duty to their clients in respect of their recommendations. But regulators universally seem to have concluded that these existing obligations as to product development and design and product sales should be augmented in respect of certain product types.

Finra has for some time been focused on the sales practices of broker-dealer member firms in connection with structured products. In fact, the most recent notice on complex products references prior guidance regarding particular types of structured products and reminds member firms that they should review and assess the adequacy of their controls (with respect to products that may be deemed complex) and must discharge their suitability obligations, which entail due diligence regarding product features, including potential risks and rewards. Finra poses suggested questions that should be considered by member firms during the due diligence process.

The notice restates Finra's guidance in Notice 05-59 (relating to structured products) that brokers should consider limiting the sales of certain structured products to what it terms options-eligible accounts, or otherwise adopt sufficient guidelines for determining which accounts should be eligible to purchase these products. The notice further reminds member firms that they should establish post-approval review processes in respect of new and complex products and that specialised training also may be appropriate for registered representatives charged with selling complex products. Finally, the notice suggests that member firms consider the financial sophistication of customers when recommending a complex product, engage customers in a discussion of product features, risks, rewards and costs, and consider whether less complex or costly products would achieve similar goals.

In the UK, the Financial Services Authority (FSA) reminded firms that they should undertake a review of their product approval procedures, product design and development process (including stress testing products), and their marketing of products, including their choice of distributors and their disclosures. This was in response to concerns that 'the growing number of structured product sales, as well as increasing product complexity, [were] placing a strain on firms' systems and controls'.

Both the Securities and Exchange Commission (SEC) and Finra have also taken an interest in the role that distributors play in the sales process. Distributors are often the principal or the last point of contact with retail investors. Regulatory actions in the US arising from weak sales and supervisory practices of some distributors have raised the stakes for issuers and underwriters (or product manufacturers) of structured products.

Although it is common practice to rely on distribution agreements to document the product provider-distributor relationship, product providers have been more keenly focused on conducting additional inquiries regarding the compliance culture and practices of their distributors. There are varying know-your-distributor practices, but most product providers have been conducting more robust initial screenings of prospective distributors, examining their compliance and litigation backgrounds, and making inquiries regarding the types of products offered by the distributor to assess whether the distributor is experienced in selling complex products.

In the US, the product producer will want to understand the distributor's process for approving the structured products it offers and discharging the distributor's know-your-customer and suitability obligations. Often much of this information may be elicited through questionnaires and supplemented through discussions or site visits.

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A product provider will also want to consider whether the distributor has undertaken training sessions for its sales and supervisory personnel. A product producer also may want to consider whether only certain distributors should be permitted to sell particular types of structured products. A product producer may want to offer more conservative certificates of deposit more broadly through numerous distributors, while offering non-principal protected products with complex pay-off profiles through distributors that have a proven compliance track record and the resources to conduct the necessary training for its registered representatives and supervisors.

Scared into merit-based regulation

Although one could argue that the existing regulatory frameworks applicable to registered entities and their employees should be sufficient to safeguard against inappropriate sales, it is difficult to question the regulators' investor protection objectives.

In certain instances, even these more aggressive steps to protect retail investors by focusing on careful product vetting, more training and supervision of sales representatives, robust disclosures, and special suitability assessments, have not been deemed sufficient by regulators. Regulators have been moving in the direction of product intervention or product banning. In certain jurisdictions, regulators are becoming engaged actively even before a product reaches the market by intervening at the product development stage.

> **"Various regulators have noted that disclosure alone may not be enough to protect investors"**

The FSA has stated that all product manufacturers of structured investment products must identify the target market for the product to establish whether the products serve a real investor need or provide an actual benefit. In other jurisdictions, regulators have determined that certain specialised or non-mainstream products are simply unsuitable or overly complex for retail sales and should be banned.

These efforts suggest a regulatory perception that the problem is the product, rather than the sales process, or the disclosures. The chair of the European Securities and Markets Authority (Esma) commented publicly in September that, while they are not against complexity per se, they are developing an investor communication explaining the risks of investing in complex products and are working on proposals to improve implementation standards for existing rules relating to information to clients, suitability and appropriateness. In addition, he stated that Esma's aim is to consider what it can do at a European level to improve investor protection in relation to distribution of complex structured products by establishing common ground for distribution frameworks across the EU.

Even in the US, which has long relied on a disclosure-based model for its securities regulation, Finra head Richard Ketchum noted in a September 2012 speech 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." This would be a fundamental change as far as the US is concerned. As a general matter, one is left to wonder whether the experience of the financial crisis was so bruising that regulators see product intervention or banning as the only alternative available to them, even when it is clear that the concerns stem principally from sales practices.

Various regulators have noted that disclosure alone may not be enough to protect investors because investors may not have the sophistication to understand the disclosures. Presumably, this is even the case when these disclosures are reduced to a few pages, or because investors will not read disclosures provided to them. Any consideration of costs and benefits is likely to suggest that a number of other measures could be undertaken to improve financial literacy or to encourage investors to read disclosures that pertain to their own investments and financial welfare, versus foreclosing investment opportunities to all retail investors for fear of having documents going unread by some.

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