Retail Structured Products
The latest regulatory developments

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Looking at …

1. What the current rules are for manufacturing, distributing and advising on retail structured products
2. How these rules are changing
3. Recent documentation changes – Prospectus Directive
4. Enforcement and Supervision
UK/EU regulatory background

- Focus of EU regulation (e.g. Markets in Financial Instruments Directive) had been on the sales process rather than on product manufacture
- Notable exceptions in the funds sector (i.e. UCITS funds) and for some aspects in relation to transferable securities (i.e. Prospectus Directive regime)
- Very light touch on deposit products due to capital protection and (previous) confidence on solvency of banks
- Completely different EU regulatory regime for sale of insurance products (Insurance Mediation Directive)
- UK regime applies many similar rules to “designated investments” (includes securities/investment products and life insurance products with an investment element)
- Changes to the rules now very much driven by EU reforms, which are focused on manufacturers as well as distributors
Policy drivers for change

- “Patchwork of uncoordinated regulation” (MiFID, IMD, UCITS, PD) – need for harmonisation across sectors
- Minimise discretions available to Member States to reduce differences in rules between jurisdictions
- Market and technological developments have outpaced MiFID I, undermining the level playing field
- The financial crisis has challenged previous assumptions that minimal transparency, oversight and investor protection are conducive to market efficiency
- MiFID I has not led to the “optimal outcomes” that the regulators wanted
- EU is particularly concerned by the marketing and sale of complex products, as well as structured retail product governance practices – ESMA issued opinions in February and March 2014 respectively on these issues
Concern over retail structured products (RSPs)

- Growth in RSP market due to low returns from more traditional forms of investments or deposits and increased volatility in the underlying markets
- RSPs allow retail investors access to asset classes, market segments and investment strategies that were previously only available to professionals
- From an investor protection perspective, regulators consider that this trend poses certain risks for retail investors:
  - complexity means investors may not be able to understand the risks, costs and expected returns of some complex products and/or the drivers of risks and returns
  - use of behavioural economics in packaging/marketing which increases the likelihood of clients opting to invest in complex products without fully understanding the risks or asking the right questions
  - if investors do not have the ability to make informed investment decisions, this increases the likelihood of consumer detriment
- Industry argues that complexity is not in itself problematic if distributors can explain the risks involved properly
Proposed EU changes

1. MiFID II and MiFIR (Markets in Financial Instruments Directive and Regulation) – published in the Official Journal in June 2014 and is expected to enter into force in early July 2014
2. PRIIPs (Packaged Retail and Insurance-based Investment Products) Regulation – Key Information Documents for investment products - long debated, but final text negotiations are now complete
3. MiFID II/MiFIR/PRIIPs are Level 1 legislation – much of the detailed content will come through Level 2/Technical Standards
4. Likely all rules will be in practical effect by end of 2016
MiFID II
Fundamental principles

- EU - MiFID client’s best interests rule - when providing investment services to professional clients and retail clients, a firm must act honestly, fairly and professionally in accordance with the best interests of its client.
- According to ESMA, if it appears that a particular complex product will never meet the best interests of clients, or there is a lack of sufficient information available to ascertain the main features and risks of a product, distributors should not offer advice on that envisaged product or sell it at all.
MiFID perimeter changes

- Changes to financial instruments/services
  - issuance of deposits with non-interest rate returns (i.e. structured deposits) will be brought within the remit of these protections under MiFID II
  - issuance and sale of financial instruments by investment firm or credit institution, with or without giving advice, will be the investment service of execution of orders on behalf of clients
- MiFID II will amend the Insurance Mediation Directive (IMD) II in order to provide equal investor protection of equal weighting to insurance-based investments. The amendments will only apply to insurance-based products with an investment element that is expected to provide a variable rate of return.
  - note, insurance-based products will not become “MiFID products” as their detailed requirements will be set out in IMD II
Future approach to regulation of structured products

- The International Organisation of Securities Commissions (IOSCO) established a regulatory toolkit for use by competent authorities in their approach, organised “along the value chain” of the product it covers:
  - regulatory approach to retail structured products
  - design and issuance of products
  - disclosure and marketing in relation to products
  - product distribution
  - post-sale practices
- ESMA opined that the implementation of sound product governance arrangements among both manufacturers and distributors is essential to increasing investor protection. As a result, two sets of product governance policies (for manufactures and distributors) have been proposed
- The obligations will focus on governance only, and are not aimed at changing a product’s level of risk
Proposed product governance obligations – manufacturers

- Examples of proposed manufacturer requirements under MiFID II (and in accordance with ESMA draft technical advice) include:
  - design of products to meet the needs of a specified target market
    - at a level sufficiently granular to guarantee exclusion of incompatible investors.
    - undertaking scenario analysis of poor investor outcomes, assessing, for example, the effects of market deterioration and/or materialisation of counterparty risk
  - analysis of potential conflicts of interest (including those related to remuneration) as part of the product development process each time a product is generated
    - look at potential for the client to be adversely affected by exposures opposite to those previously held by the firm or those that the firm wants to hold after the product’s sale
  - providing adequate information to distributors, enabling them to understand and sell the product properly
    - including information on appropriate sales channels for the product, the product approval process and results of target market assessment
Proposed product governance obligations - distributors

- If product governance arrangements apply to more than one distributor (e.g. product is recommended by one firm and made available to the client by another) the final distributor in the chain will be ultimately responsible, though intermediate distributors will be subject to certain obligations.

- Examples of proposed distributor requirements include:
  - establishing product governance processes to ensure that products and services are compatible with the objectives and needs of an identified target market, ensuring investors needs will not be compromised by funding or other pressures
  - conducting periodic reviews of product governance processes, with the involvement of the Compliance function in order to detect any risk of failure to comply with obligations
  - ensuring that the level of product information obtained from third country and non-MiFID manufacturers is of a reliable and adequate standard to be reassured that the characteristics, objectives and needs of the target market will be met
Client categorisation

- Retail clients
- Professional clients (elective and per se)
- Eligible counterparties (elective and per se)
- Slight changes to be made to definitions under MiFID II
- Chains of firms – who is your client?
  - current position
  - post EU reforms
Client communications

- All communications
  - fair, clear & not misleading
  - appropriate & proportionate
- Retail communications
  - balance benefits & risks
  - understandable by average recipient
  - do not diminish important items or warnings
  - comparisons fair
- Specific rules on past, simulated past and future performance
- Responsibility usually rests with those issuing or communicating the promotion
- More detailed requirements on charges post EU reforms, and likely to be improved transparency around potential conflicts/inducements (e.g. payments by manufacturers to distributors)
Suitability – investment advisers and portfolio managers

- Current requirement – firms providing investment advice or carrying out portfolio management must obtain necessary information regarding a client's knowledge and experience relevant to the specific product, their financial situation and investment objectives to assess suitability on a transaction by transaction basis.

- Proposed requirement for providing investment advice, a firm must:
  - state if advice is independent & based on broad/narrow market analysis
  - if independent advice being provided
    - disclose proportion of total financial products analysed
    - not take 3rd party fees/commissions (current UK rules ban such fees/commissions to any investment adviser)
  - state whether it will provide periodic assessment of suitability of the financial instrument recommended
  - assess client’s risk tolerance and ability to bear losses

- No requirement to ensure suitability if not providing investment advice or carrying out portfolio management.
Appropriateness (1)

- **Current requirement** – firms not providing investment advice/portfolio management services must ask clients as to their knowledge and experience relevant to the specific product in order to understand the risks involved and whether the product and/or service is appropriate for the client

- **Proposed requirement**
  - similar to existing requirement, no appropriateness checks required for execution only services or receiving and transmitting order services for liquid/non-complex financial instruments only
  - complex instruments include financial instruments embedding a bond, derivative (i.e. most RSPs) or structure that makes it difficult for the client to understand the risks involved
  - ESMA has proposed criteria for non-complex instruments in order to extend the scope of financial instruments that are subject to the MiFID II obligation
Appropriateness (2)

- In order to be considered non-complex, product characteristics will have to meet the following criteria (in addition to the four already existing under MiFID Article 38):
  - it shall not incorporate a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay out (including, for example, investments with conversion rights)
  - it shall not include any explicit or implicit exit charges that have the effect of making the investment illiquid even if technically frequent opportunities to dispose or redeem it would be possible
Product intervention (1)

- Regulatory authorities (i.e. FCA)
  - may prohibit or restrict any type of financial activity or the marketing, distribution or sale of any financial instrument
  - if reasonably satisfied that the activity or instrument gives rise to significant investor protection concerns or poses a threat to the orderly functioning and integrity of financial markets or the stability of the financial system

- ESMA
  - similar powers to EBA (in relation to structured deposits) to prohibit or restrict but only “temporarily” (for three months), but there is potential to renew prohibition/restriction indefinitely
Product intervention (2)

- Factors which must be taken into account before exercising product intervention powers include:
  - the degree of complexity of a financial instrument and the relation to the type of client to whom it is marketed and sold
  - the size or the notional value of an issuance of financial instruments
  - the degree of innovation of a financial instrument, an activity or a practice
  - the leverage a financial instrument or practice provides.
- Draft technical guidance from ESMA also imposes additional factors, including the following:
  - degree of transparency of the product/activity
  - disparity between expected return and risk of loss
  - ease and cost with which investors can switch/sell products
  - selling practices associated with the product
PRIIPs
What are PRIIPs?

“This Regulation should apply to all products and underlying investments regardless of their form or construction that are manufactured by the financial services industry to provide investment opportunities to retail investors, where the amount repayable to the investor is subject to fluctuations because of exposure to reference values, or in the performance of one or more assets which are not directly purchased by the investor”

- Defined broadly for anti-avoidance purposes, covers units in funds, derivatives, investment insurance products and many forms of notes/bonds. RSPs will always be caught
- It excludes non-life insurance products, life insurance contracts where beneficiaries are paid on death, pension products which ultimately provide income, occupational pension schemes, deposits (not structured deposits)
Pre-contractual information requirements

- Proposal: new disclosure instrument to regulate pre-contractual disclosures of PRIIPs
  - would require a pre-contractual product disclosure for all PRIIPs sold in the retail market: a Key Information Document ("KID")
  - aimed at helping retail investors understand, compare and use information provided to them about investments
    - KID must be kept up to date and updated KIDs made available promptly
- Interaction with Prospectus Directive requirements
- Potentially separate liability issues for KIDs
Who produces the KIDs?

- Document responsibility
  - product manufacturers would be responsible for preparing PRIIPs KIDs and ensuring publication on their website/ a central EU website
  - distributors responsible for providing the KID to investors in good time prior to entering into any agreement in one of three forms (subject to relevant criteria):
    - on paper (presented face-to-face)
    - in a durable medium other than paper
    - via a website
What will the KIDs look like?

Document design
- PRIIPs KID differentiated from other disclosures, e.g. prospectus
- intended merely to draw out key information – not a sales document
- a stand-alone document
- all information to be accurate, fair and not misleading as well as in language which is clear and comprehensible
- Must be available in one of the official languages of the part of the member state in which the PRIIP is to be distributed
- in a form that is understandable to aid decision-making by retail investors
- must be short (no more than 3 A4 pages in length) and focused on key information
What will the KIIDs say?

- Standardised intro

  “This document provides you with key information about this investment product. It is not marketing material. The information is required by law to help you understand the nature, risks, costs, potential gains and losses of this product and to help you compare it with other products.”

- Must contain the name of the PRIIP, the identity, and contact details of the PRIIP manufacturer, information about the competent authority of the manufacturer and the date of the document

- Detailed content requirements on product description, costs, risks (risk-reward profile), how long product should be held, potential returns/losses, complaints procedure and other relevant information

- Cross-references may only be made to non-marketing documentation (e.g. prospectus)
KID Comprehension Alert

- If an investment is “not simple and difficult for retail investors to understand”, the KID must include a comprehension alert to the investor using the following prescribed wording:
  
  “You are about to purchase a product that is not simple and may be difficult to understand”

- A product shall be regarded as such if:
  
  • it invests in underlying assets in which retail investors do not commonly invest
  • it uses a number of different mechanisms to calculate the final return of the investment, creating a greater risk of investor misunderstanding
  • the investment's pay-off takes advantage of retail investor's behavioural biases (such as a teaser rate followed by a much higher floating conditional rate, or an iterative formula)
The Prospectus Directive
Documentation angle: the PD

- Prospectus Directive (2003/71/EC)
- A summary by way of reminder
  - (Non-exempt) public offer or listing on a regulated market
  - Base prospectus plus Final Terms
  - Perceived abuse of Final Terms
- A "point in time" document
  - Transparency Directive obligations to release information
- Retail cascades and permission to use the Base Prospectus
The PD Amending Directive

- Effective July 2012 with grandfathering provisions
  - Particularly relevant for programme updates in early 2013
  - Early chaos and still “teething” issues even now
- Final Terms – much more prescriptive
  - Categories A, B and C
- Affects RSP issuers particularly badly
  - Pay-out formulae must be contained in the Base Prospectus
  - Cost implications and competition between issuers?
- Issue-specific summary
  - Prescriptive format set out in Base Prospectus
  - Completed for each trade – time and cost
Where are we going and why?

- What is the investor actually supposed to read?
  - Whole Base Prospectus (plus Final Terms)?
  - Summary plus issue-specific summary?
  - PRIPs KIID?

- What does the investor actually read
  - Termsheet
  - Marketing material?
  - Perhaps the KIID?

- If something goes wrong, they will try to hang their hat on any or all of the above – different liability standards

- Lack of convergence of MiFID and PD regimes
  - Current PD review
Supervision & enforcement

Simon Morris
Looking at …

1. The FCA view of the world
2. Expectations of governance
3. Adequacy of marketing material
4. Suitability of advised sales
5. And when it all goes wrong …
1. The FCA view of the World
What’s the FCA looking for?

… the FCA will be behaving differently from City watchdogs of the past. We won’t be captured by rulebooks and procedure. We’ll be far more focused in future on the consumer. **Putting the customer at the heart of everything** we do, and expecting the same attitude from firms.

*Martin Wheatley March 2013*

There is an important continuum between wholesale and retail conduct, and we know how easily **poor conduct in one can bleed into other areas** and become pervasive through the financial system.

*FCA speech (18 June 2013)*
The FCA policy

... our new style of supervision means we will *intervene earlier in a product’s lifespan* ... We will ... **scrutinise firms’ product governance** – how firms design, operate and sell products ... [to] set outcome-focused responsibilities on firms to govern the design and delivery of products in a way that delivers fair results.

**Provider firms** will be expected to have robust procedures to assess their target market, perform adequate stress testing, and manage the product risks for consumers ...

If necessary, we will be **ready to intervene directly** by making product intervention rules to prevent harm to consumers – for example, by restricting the use of specified product features or the promotion of particular product types to some or all consumers ...

*The Journey to the FCA (Sept 2012)*
FCA product intervention policy

- To address potential or actual consumer detriment
- Looking at breadth, depth and context
  - How many? How much? How vulnerable?
- Outside FCA’s view of proper market
  - Obnoxious features
  - Market cannot address – barriers to entry or exit
- For example
  - Single premium PPI – to cap remuneration
  - SCARPs – to require advice (?)
What the FCA is told to look for …

When carrying out their supervisory duties, national competent authorities (NCAs) should monitor that firms have in place adequate internal controls for products and services development when providing clients (both retail and professional) with investment services in complex products, in order to avoid detrimental practices toward clients.

If, following firms’ due diligence, it appears that a particular complex product will never meet the best interests of their clients, or there is a lack of sufficient information available to ascertain the main features and risks of a product, NCAs should monitor that firms do not offer advice on that envisaged product, or sell it at all.

ESMA Guidance on Complex Retail Products February 2014
When does the FCA review a retail structured product?

- FCA Thematic visits
- FCA Supervisory visits
- Responses to FCA communications eg Dear CEO letters
- Business/compliance monitoring
- Complaints analysis
What does the FCA look for?

The manufacturer’s, the packager’s and the distributor’s

1. Business model
   a) Revenue, profit, value chain, subsidisation, extraction

2. Strategy

3. Governance
   a) Identification & management of risk

4. Culture
   a) Tone, training, remuneration, incentives
2. Governance in structured product design

The FCA expects to see …

1. Board engagement
2. Senior management oversight
3. TCF champion active
4. Embedding in processes
5. Documented and consistent
6. Regular challenge & review
7. Maintaining audit trail
Digging down …

- Governance committee
  - Clear terms of reference & elevation procedure
- Post-launch review
  - Annual review
- Expectation that will identify market
  - Consumer or distributor research
  - Panel test the actual product
- Design
  - Need
  - Risk
  - Objectives
  - Experience of customers
  - Will it be advised
  - Tax

- Design features
  - Lead time
  - Choice of index: esoteric/volatile
  - Can customer assess the return?
  - FSCS/FOS
  - Choice of counterparty
  - Stress tested

- Choice of distribution channel
  - Intermediation increases regulatory risk
  - Need for TCF MI
  - Value chain is FCA w/s focus
  - Due diligence, restrict, train, monitor

- Clarity of marketing material
What MI should a manufacturer gather?

– Inward looking
  • Performance

– Outward looking
  • Distribution trends
  • Size
  • Persistency

– In either case
  • Identify the indicators
  • Capture the data
  • Calibrate and verify it
  • Convey the information & action it.
3. Adequacy of marketing material

The test of *fair, clear and not misleading* which the FSA interprets as

- Immediate balance of risk/reward
  - The “news headlines” test
- Comprehensible
  - In the face of complexity
- No disguise or omission
  - Often judged with hindsight
Good practice

The “page three” headings
- Term
- Market risk: income and capital return criteria
- Counterparty risk

And nearby
- Is this Plan right for me?
  - Term & access
  - Return
  - Risks of loss
  - Balanced/concentrated
- Worked examples of good & bad

And then
- Details
  - Issuer
  - Calculation income & capital
  - Taxation & charges
- Compensation arrangements
- Indices & performance
- Counterparty – how assessed; ratings & outlook
- Risks
- FAQ
- T&C
A recent manufacturer/distributor breach

1. The product brochures gave undue prominence to the potential maximum return ... CSI knew ... it was almost impossible to achieve the maximum return ...

2. This led to an unfair presentation of the likelihood of achieving the maximum return

3. CSI’s financial promotions procedures did not provide for any holistic periodic review of their compliance with regulatory requirements.

Credit Suisse FN 16 June 2014

1. The majority of the YBS financial promotions ... cited the potential maximum return figure as one of the key promotional features of the product even though YBS was aware it was almost impossible to achieve this.

2. While it was necessary to refer to the cap on returns in the financial promotions ... it was highly inappropriate to emphasise the maximum return in this way.

YBS FN 16 June 2014
Limited Offer until 28 January 2010

Guaranteed Savings Growth

Minimum growth of 15% gross*

At the end of the full 6-year term

with potential maximum growth of 72% gross*

based on potential FTSE® 100 Index growth during the full 6-year term

• 100% capital protection if held to maturity
• 0.5% bonus for funds cleared by 26 November 2009
• Minimum investment £3,600, maximum £50,000
• Account must be held for the full 6-year term
• If you exit early you will get back less than you invested

Money with a Yorkshire accent.

Credit Suisse

Yorkshire
4. Suitability of advised sales

The COBS rule

− Obtain necessary information financial situation, knowledge, objectives
− Take reasonable steps to ensure personal recommendation is suitable
  • FSA has notional 10%/25% concentration thresholds.
− To have reasonable basis to believe transaction
  • Meets objectives
  • Risks are understood
  • Can bear financial risks.
− And keep a record (may be suitability report)
Protections on suitability

- Targeting product
- Providing training
- Literature clear
- Adequate records – suitability letter
- Give the suitable advice supplemented by
  - Welcome calls
  - Mystery shopping
  - Accompanied meetings
  - Monitoring distribution, performance, persistency & complaints
5. What is driving enforcement on retail structured products for manufacturers?

<table>
<thead>
<tr>
<th>Product manufacture</th>
<th>Point of sale activities</th>
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<tbody>
<tr>
<td>a) Not ascertaining real need</td>
<td>a) Inaccurate product material</td>
</tr>
<tr>
<td>b) Not panelling product</td>
<td>b) Not monitoring distributor</td>
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<td>c) Not selecting distributors</td>
<td>c) Not engaging with distributor</td>
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<tr>
<td>d) Not training distributors</td>
<td>d) Not expecting product feedback</td>
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<tr>
<td>e) Not avoiding conflicts (rare)</td>
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What is driving enforcement on retail structured products for distributors?

**Fundamental requirements**

a) Not understanding the product*

b) Weak front office controls

c) Poor training*

d) Weak business monitoring

e) No compliance monitoring

f) Weak management information*

g) Senior management not engaged

h) Inappropriately incentivised*

i) Oblivious to changing market*

**Point of sale**

a) Inaccurate product material*

b) Failed to analyse available data

c) And on suitability

   a) Poor know-your-customer

   b) Not get attitude to risk

   c) Poor record of the facts

* Where the provider can help
What does bad look like? (1) the distributor

The **vast majority of Sesame’s sales were flawed** because:

- there was a mismatch between many customers’ stated **investment objectives and attitude to risk** and the product sold;
- the **suitability letters** provided to customers stated incorrectly that income or capital growth was guaranteed; and/or
- customers were advised incorrectly that the Keydata Products were **low risk**.

In every case reviewed by the Authority, Sesame failed to **explain to customers all of the key risks and failed to give a balanced view** of the advantages and disadvantages of the Keydata Products.

Sesame (June 2013)
What does bad look like? (2) the distributor

UBS failed to **conduct adequate due diligence** on AIG Fund before selling it to customers
– Did not adequately train advisers
– Did not **adequately capture customers’ tolerance to risk**...
– Recommended the Fund to some customers even though it did not provide them with the necessary **level of capital security**
– Indicated to customers that the **Fund was a cash fund** which invested in money market instruments. was invested in assets which did not meet this description ...
– Failed to provide provide **a fair and accurate explanation** of the risks.

**UBS (February 2013)**
What does bad look like? (3) intragroup sales

Credit Suisse UK:
- failed to have in place adequate systems and controls in respect of the determination of customers’ attitudes to risk ...
- failed to take reasonable care to adequately evidence that the SCARPs it recommended to its customers were suitable
- failed to have in place adequate systems and controls surrounding the levels of issuer and investment concentration within customers’ portfolios ...
- did not effectively monitor its staff to ensure that they took reasonable care to ensure the suitability of their advice ...

Credit Suisse (October 2011)
So in summary

1. The FCA is alert to customer detriment
2. And aims to head it off by supervisory work
3. And is looking for
   a) Strategy
   b) Governance
   c) Culture
   d) Design
   e) Distribution
4. And absence leads to enforcement
5. There are numerous cases on distributors
6. And coming soon, on manufacturers and distributors.
Any questions?