New York Law Journal
Compliance
An ALM Publication
WWW.NYLJ.COM
MONDAY, NOVEMBER 7, 2011

Structured Products **Under a Microscope**

BY ANNA T. PINEDO

IN THE AFTERMATH of the financial crisis, financial engineering engenders suspicion and products perceived to be complex attract regulatory attention. Structured products are among the products that have come under scrutiny. In part, as discussed below, some of this attention may be unwarranted and may be the result of a case of mistaken identity. Often, financial products bearing very different characteristics are lumped together and referred to as "structured products" if they entail any structuring. For example, articles may discuss structured finance products or structured credit products, like collateralized debt obligations or collateralized loan obligations, 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 are debt securities with cash flow characteristics that depend on the performance of one or more reference assets. The prototypical product may be a senior note the performance of which is tied to the S&P 500 Index. The market for these products has proven resilient and has grown in recent years, with reported sales reaching nearly $54 billion in 2010. These products are designed to meet the risk/reward needs of investors and offer distinct benefits that cannot be obtained from other investments. That being said, the regulatory structure applicable to these products is difficult to navigate. This article discusses recent regulatory and enforcement developments and highlights disclosure and compliance concerns for market participants.

ANNA T. PINEDO *is a partner at Morrison Foerster in New York.*

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Regulatory Framework

Structured products include equity-linked, index-linked, interest rate-linked, commodity-linked, and currency-linked instruments. Although from a cash flow perspective a structured product may look like a combination of a traditional debt security and a derivatives contract, structured products are not derivatives contracts. Structured products simply involve trading away a portion of the full potential upside associated with a direct investment in the reference asset (like an investment in the S&P 500 Index), in exchange for a return of principal at maturity (subject to the issuer's credit risk), or in exchange for assuming some lesser risk to the reference asset. These products may be structured as senior debt securities offered by an issuer (usually a financial institution that is a well-known seasoned issuer) pursuant to its shelf registration statement, or they may be structured as market-linked certificates of deposit offered by a bank.

As a result of the various forms that these products may take, there is no single regulation or body of regulation applicable to the issuance, sales and marketing of structured products. For example, in the first instance, the applicable regulatory scheme may turn on whether the product is a security (and whether it is a registered security or a security offered in a private placement or as a bank note) or a bank product. The nature of the reference asset may raise particular considerations, as we discuss below in the context of commodity-linked products. Many of these products have distinct tax benefits, so tax considerations often are central to the structuring process.

Employee Retirement Income Security Act (ERISA), Investment Company Act and Investment Advisers Act questions also need to be vetted carefully. The nature of the potential investors will trigger particular concerns—Is it an institutional product? A retail product? Will it be sold in small denominations? Will it be marketed only to certain types of investors (e.g., accredited investors, qualified institutional buyers (QIBs), investors cleared for options trading)? In addition, the broker-dealers that market structured products are subject to regulation by a self-regulatory organization. For the issuer of these products, other considerations arise that are not unique to structured products offerings, but rather arise in connection with securities offerings generally. These include, for example, issuer blackout periods, authorization of the issuance and sale of the securities, availability of an effective registration statement, etc. Likewise, there are Financial Industry Regulatory Authority (FINRA) regulations applicable to all securities offerings, such as those relating to communications and underwriting compensation, which also must be considered in the context of a structured products offering.

Broker-Dealer Standard of Care

Broker-dealers generally are not subject to a fiduciary standard of care. Although not considered "fiduciaries," broker-dealers owe various duties to their customers, such as the duty to recommend "suitable" investments, obtain "best execution" when effecting trades and charge fair commissions or mark-ups. Also a general matter, FINRA/ National Association of Securities Dealers (NASD) rules require that firms ensure their communications with the public are based on principles of fair dealing and good faith, are fair and balanced and provide a sound basis for evaluating the facts about any particular security, industry or service.

Risk disclosures in a prospectus or supplement do not cure deficient disclosure in sales materials. FINRA Rule 2090—the know-your-customer rule—requires that firms "use reasonable diligence, in regard to the opening of every account, to know (and retain) the essential facts concerning every customer." Rule 2111 (replacing NASD Rule 2310) requires that firms have a reasonable basis for determining that a product is suitable for investors in general and that it is suitable for each specific customer prior to recommending the purchase or sale of a security.

Recent changes to the suitability rule also identify a quantitative suitability assessment that requires a broker-dealer to assess whether a transaction or series of transactions (if viewed together) are suitable for the client. The rule requires firms to make reasonable efforts to obtain information concerning: the customer's financial status, tax status, investment objectives, time horizon, liquidity needs, risk tolerance and any other information considered reasonable by the member or registered representative in making recommendations to the customer. A firm's registered representatives must familiarize themselves "with each customer's financial situation, trading experience, and ability to meet the risks involved with such products."

Sales and Marketing

FINRA (and its predecessor, the NASD), referred to herein throughout as FINRA) has issued various Notices to Members (NTMs) and alerts that relate directly to the sales and marketing of structured products. In November 2003, FINRA issued an NTM titled "Non-Conventional Investments,"[1] which was followed in April 2005 by one on "New Products"[2] and in September 2005 on "Structured Products."[3]

The three notices raise similar issues. FINRA notes that members must develop and implement written procedures to identify and consider new products, as well as post-approval follow-up and review procedures. FINRA reminds members that, in order to discharge their suitability obligation in connection with marketing and selling new products or structured products, members should conduct adequate diligence. Members should conduct the diligence necessary to permit them to understand product features. The nature of the diligence will vary by product, but should take into account distinct product features and should include an understanding of the liquidity of the product, the creditworthiness of the issuer, the principal, return and/or interest rate and the tax consequences.

> As **commodity-linked products** became increasingly popular, FINRA published **Regulatory Notice 10-51**, reminding firms of their **sales practice obligations** for commodity futures-linked securities.

In NTM 5-59, FINRA notes that members should consider whether an investment meets the reasonable basis suitability standard if it is priced "such that the potential yield is not an appropriate rate of return in relation to the volatility of the reference asset based on comparable or similar investments." Given structured products are varied, comparing the yield/ volatility profile of "similar" investments may pose challenges. Members also must perform a customer-specific suitability analysis to ensure an investment in the product is suitable on a customer-by-customer basis. This requires taking into account the customer's financial and tax status, investment objectives and other similar information—without placing undue reliance on net worth alone. NTM 5-59 suggests members consider whether an investor meets the suitability requirements for options trading.

Any offering or sales material should provide balanced disclosure of the risk and rewards associated with the particular product, especially when selling to retail investors. In particular, the notices emphasize that many unique features associated with structured products may not be readily understood by retail investors. Members should avoid potentially misleading characterizations of structured products in offering or sales materials (for example, referring to the products as "income-producing" or "conservative" or "yield-enhancing"). NTM 5-59 noted that offering materials that "omit a description of the derivative component of the product and instead present such products as ordinary debt securities would violate [NASD] Rule 2210."

Offering documents also should highlight and explain the risks associated with structured products, which generally include market risk, interest rate risk, a risk of embedded leverage, the risk of reduced liquidity, issuer credit risk, uncertain tax treatment or adverse tax consequences and the possibility that there may not be any current income for the holder. Risks specific to each product or structure should be explained as well.

Following the failure of Lehman Brothers, holders of Lehman Brothers structured products, including principal-protected products, faced losses. In legal or regulatory actions, holders of Lehman principal-protected notes alleged that they believed "principal-protected" meant repayment of principal was guaranteed and did not understand that the notes were senior unsecured debt obligations of the issuer, subject to issuer credit risk. Regulators took note and issued new guidance.

In December 2009, FINRA released Regulatory Notice 09-73 relating to principal-protected notes, which reminded members that communications must be fair and balanced and provide appropriate disclosures, including disclosures regarding issuer credit risk. FINRA cautioned that members should conduct reasonable suitability assessments prior to recommending principal-protected notes. Finally, FINRA emphasized that members must train their registered representatives regarding the terms, conditions, risks and rewards of these products.

The SEC also has cautioned that product names might confuse investors and, in particular, references to "principal protection" should be accompanied by clear and prominent language regarding issuer credit risk. In proceedings relating to Lehman principal-protected notes, regulators emphasized that registered representatives needed to implement appropriate product approvals, suitability guidelines, account opening procedures, and structured product specific training. In July 2011, the SEC and FINRA jointly issued an Investor Education Release regarding principal-protected structured products that focused principally on disclosure considerations.

In 2010, FINRA issued Regulatory Notice 10-09 regarding reverse convertible securities, which had become quite popular. The notice focused on sales and marketing communications relating to reverse convertibles and recommended that members ensure investors understand that reverse convertibles do not provide for principal protection and as a result investors may experience losses on their investments. The notice emphasized that investors should understand the product, the payout structure, that the product is a buy-and-hold product and the limited secondary nature.

To the extent that the firm publishes its own research regarding the reference asset, the representative should disclose the content of the research and how (and whether) the research is relevant to a purchase recommendation. Members should not suggest that reverse convertibles are ordinary debt securities and cannot present annualized yield or coupon information for reverse convertibles in a misleading manner. Consistent with prior guidance, the notice emphasizes the member's suitability obligation and its responsibility to train and supervise its registered representatives. FINRA enforcement actions relating to reverse convertibles have cited member firms for unsuitable sales, inadequate supervision of structured product sales and failures to monitor accounts for concentrated positions in reverse convertibles.

As commodity-linked products became increasingly popular, FINRA published Regulatory Notice 10-51, reminding firms of their sales practice obligations for commodity futures-linked securities. The notices highlighted certain risks that may result from the methodologies used in connection with commodity futures-linked securities, including possible deviation between the performance of the commodity futures-linked security and the performance of the referenced commodity. Each strategy has different benefits, risks and costs, and the appropriateness of a particular methodology depends, in part, on the investor's needs and preferences. The deviation between the performance of the commodity futures-linked security and the performance of the referenced commodity's spot price can produce unexpected results for investors who are not familiar with futures markets, or who mistakenly believe that commodity futures-linked securities are designed to track commodity spot prices. The notice advised that registered representatives and potential investors should discuss, among other things:

- the commodity, basket of commodities or commodities index that a given product tracks;
- the product's goals, strategy and structure;
- that commodities prices, and the performance of commodity futures-linked securities, can be volatile;
- that the use of futures contracts can affect the performance of the product as compared to the performance of the underlying commodity or index;
- the product's methodology, including its strategy, if any, for managing roll yield and other factors that may affect performance; and
- the product's tax implications.

Useful Reminders

Structured products issuers and broker-dealers that distribute them should anticipate that regulators will remain focused on this area. Consistent with their objective of protecting investors, regulators will seek to reduce complexity for retail investors and seek greater transparency and clarity in product disclosures. Moreover, given economic uncertainty and the losses borne by investors in complex structured credit products, concerns are likely to continue to be raised as to whether market-linked products are too complex for retail investors.

Many of these discussions are likely to gloss over the distinctions between complexity and riskiness and may fail to distinguish among different types of retail investors with differing levels of sophistication. In light of the regulatory environment, market participants should take care to:

- review their new product approval process;
- adopt detailed policies and procedures that address the distinct issues posed by structured products;
- address know-your-customer and suitability obligations;
- implement approaches to monitor concentration of structured products, single issuer exposures, and trades prior to maturity in client accounts;
- design comprehensive mandatory training and education specific to structured products; and
- focus on disclosures.

Special attention should be paid to product names, descriptions of payout structures and product features, and clear discussions of the product's risks, including the lack of a secondary market, the special tax features, the buy-and-hold nature of the products, the fees and expenses associated with the product, and the potential conflicts of interest presented by the investment.

Issuers of structured products have made effective use of the ability to file educational materials as free writing prospectuses. With renewed focus on point-of-sale disclosures, the flexibility to use free writing prospectuses for product descriptions will prove essential. There also are a number of changes on the horizon, including those that may arise as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act. For example, the imposition of a fiduciary duty on broker-dealers, and the regulation of over-the-counter derivatives, are likely to affect the structured products market. Market participants will need to monitor rulemaking in these areas and add developments in these areas to their to-do lists.

1. NASD Notice to Members 3-71 (November 2003).
2. NASD Notice to Members 5-26 (April 2005).
3. NASD Notice to Members 5-59 (September 2005).