

Structured Thoughts

News for the financial services community.



IN THIS ISSUE:

FINRA Voices Concerns About Exchange-Traded Notespage 1

Worth the Wait? Draft PRIPs Legislation Finally Published.....page 3

FINRA Voices Concerns About Exchange-Traded Notes

On July 10, 2012, the Financial Industry Regulatory Authority, Inc. (“FINRA”) published an investor alert titled “Exchange-Traded Notes—Avoid Unpleasant Surprises.” The investor alert can be found at: <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/TradingSecurities/P131262>. The investor alert describes the features of a typical exchange-traded note (“ETN”) and also focuses on areas of concern to FINRA.

Leveraged and Inverse ETNs

The investor alert describes how leveraged and inverse features of certain ETNs may be confusing to non-professional investors. Because of the related “reset” feature, which may be daily or monthly, the performance of a two times leveraged (including a two times leveraged inverse) ETN will not be the same as two times the performance (or two times the inverse performance) of the underlying asset. Consequently, FINRA points out that ETNs with leveraged or inverse features are more appropriate as short-term trading tools and should not be purchased by “buy and hold” investors.

This portion of the investor alert revisits concerns about leveraged and inverse exchange traded funds raised by FINRA in its investor alert dated August 18, 2009.¹

¹ The FINRA investor alert titled “Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors” may be found at <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/P119778>.

ETN Market Price Deviation

FINRA also warned ETN investors that they should compare the closing and intraday indicative values of an ETN, which are calculated and published by the issuer, or an agent or affiliate of the issuer, with the ETN's market value. The indicative prices are calculated based on the value of the underlying asset; they do not take into account other factors, such as supply and demand of the ETNs. Investors should be alert to ETNs that are trading at a premium—i.e., the market value is significantly higher than the closing or intraday indicative value of the ETN. If the ETN is trading at a premium, there is a danger that the price may drop suddenly and precipitously, as was the case with the Credit Suisse AG Velocity Shares 2x Long VIX Short Term ETNs (TVIX) in March 2012.²

ETN Risk Factors

The investor alert summarizes risks applicable to ETNs, many of which are applicable to other structured products:

- Credit risk—ETNs are unsecured debt obligations of the issuer;
- Market risk—changes in the level or value of the underlying asset will affect the value of the ETN;
- Liquidity risk—although exchange-traded, a secondary market may not develop;
- Price-tracking—the market value of the ETN may become inflated, or unhinged from the underlying asset;
- Holding period—some ETNs, particularly leveraged and inverse ETNs, are designed as short-term trading tools and should not be held for long periods;
- Call, redemption and acceleration risk—some ETNs may be called by the issuer or accelerated in certain events; and
- Conflicts of interest—the issuer's hedging activity is in potential conflict with the interests of the ETN holder.

Most ETN prospectuses disclose the risks highlighted in the investor alert, and other risks.

Conclusion

FINRA is warning investors that most ETNs are designed for investment professionals and should not be purchased by unsophisticated investors as a buy and hold type investment. Investors should be aware that although ETNs are traded on an exchange, typically the NYSE, they are not always a good investment for non-professionals.

Author

Bradley Berman
(212) 336-4177
bberman@mofo.com

² Although the investor alert does not mention TVIX by name, the fact pattern described in the investor alert closely matches that of TVIX. On February 21, 2012, Credit Suisse AG temporarily suspended further issuances of the TVIX ETNs due to internal limits on the size of ETNs. On March 22, 2012, Credit Suisse AG announced that it planned to reopen issuance of the TVIX ETNs on a limited basis. The TVIX ETNs experienced significant price fluctuations during that period.

Worth the Wait? Draft PRIPs Legislation Finally Published

More than five years after the Economic and Financial Affairs Council of the EU (“ECOFIN”) asked the EU Commission (the “Commission”) to examine the coherence of EU law relating to different types of investment products, the Commission published its draft regulation (the “Regulation”) relating to “packaged retail investment products” or “PRIPs” on 3 July. At the same time, the Commission also released draft legislation to amend the Insurance Mediation Directive, including investor protection provisions relating to insurance products and proposed amendments to the UCITS Directive focused on strengthening the function of the depositary for UCITS.

Development of the PRIPs Proposals

The world is very different now than it was in October 2007 when the Commission published its original Call for Evidence. The principal aim at that time was to seek a greater consistency and more level playing field in regulatory requirements for similar products irrespective of how they are packaged or sold. Whilst this remains an important objective of the PRIPs initiative, the intervening financial crisis increased concerns about retail investors’ understanding of structured products. The focus now is therefore much more on investor protection and the need to ensure there is sufficient transparency for investors to assess the risks involved in the investment products they buy and to assess the associated costs and fee arrangements.

Since 2007, the proposed PRIPs legislation has been somewhat pushed to one side by the huge raft of regulatory changes made in response to the financial crisis, including derivatives regulation under EMIR, the implementation of the Basel III capital requirements under CRD IV and a significant overhaul of the existing MiFID legislation. Individual EU member states have also developed rules that impact on retail financial products, including the Retail Distribution Review in the UK. However, the Commission continues to be concerned that there is still not a level playing field between the regulation of certain financial products, particularly in the areas of product disclosure and PRIPs remain an important part of its regulatory agenda.

Although the Commission’s proposals initially included point-of-sale regulations, these have now largely been moved into the draft MiFID II legislation and (in relation to insurance products) the Insurance Mediation Directive amendments. As specified below, the key element of the draft PRIPs Regulation is product disclosure and the development of a key information disclosure (“KID”). One of the primary aims of the KID is to harmonise and standardise key disclosures of information necessary to allow the investor to make an informed investment decision and easy comparisons between different products. In its previous consultation, the Commission acknowledged that there will need to be some tailoring of requirements for different products and that a “one-size-fits-all” approach is not appropriate for a wide range of structured products. However, its aim is for a high degree of standardisation for disclosure across different products.

As expected, the draft legislation is in the form of a regulation which will be directly applicable in member states without the requirement for implementing legislation. Member states will not therefore have the ability to put their own interpretation on the provisions. Further detail will be included in implementing legislation and delegated acts of the Commission. These are likely, in particular, to include more granular requirements as to the information to be contained in the KID.

We outline the principal features of the PRIPs proposals below.

Defining PRIPs (or are they now “RIPs” or “IPs”?)

The draft Regulation applies to an “investment product” which is defined as:

“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.”

This definition is broadly similar to what was proposed by the Commission in its previous consultation paper³. It is designed to cover all investment funds (including UCITS funds), all structured products (whether packaged as insurance policies, funds, securities, bank deposits, or otherwise), and any derivative. This is a significant move away from the early proposals in relation to PRIPs, which envisaged a need to have some form of packaging and would have excluded bilateral derivative contracts. The focus is now very much on any instrument whose return fluctuates by reference to the value or performance of other assets. It is therefore narrower than, for example, the definition of “retail investment product” in the UK’s Retail Distribution Review; that definition includes non-structured life insurance policies and personal pensions.

The Commission’s previous consultation had indicated that the definition of PRIPs would be supplemented by a “white list” of products which expressly either fall inside or outside of the definition. The draft legislation does not specify any products that will automatically be regarded as falling within the definition, although it is possible that this may still be included in implementing legislation or guidance by the European Securities and Markets Authority (“ESMA”). The definition does, however, expressly exclude certain categories of product from the definition including:

- Deposits with a rate of return determined by reference to an interest rate
- “Vanilla” securities that do not embed a derivative. Any securities exchangeable or convertible into shares or other securities will not fall within this exclusion
- Insurance products that only offer insurance benefits (i.e., pure protection insurance or non-life products) which provide no surrender value that is exposed to fluctuations in the performance of one or more underlying assets or reference values
- Occupational pension schemes covered by the Occupational Pensions Funds Directive or the Solvency II Directive
- Pension products for which a financial contribution from the employer is required by national law and where the employee has no choice as to the pension product provider

Although there had been a suggestion in previous consultation papers that pensions may be completely excluded from the PRIPs regime, the Regulation will now apply to pensions other than those set out above.

As indicated in previous consultation papers, the word “retail” is not featured in the definition. The Commission states in the Explanatory Memorandum published with the draft legislation that this is because it may only be determined at the point of sale whether a product is to be sold to retail investors. It notes that the disclosure would need to be produced whenever a product that falls within the definition is to be sold to retail investors. In this regard Article 5 of the draft legislation provides that the manufacturer of the product is required to draw up the KID for each investment product it produces, and shall publish the document on a website of its choice before the investment product can be sold to retail investors. Retail investors are defined as retail clients under MiFID and customers under the Insurance Mediation Directive.

Key Information Disclosure

Articles 6 to 11 of the draft Regulation set out the form and content requirements of the KID. It is the obligation of the product manufacturer to prepare the KID. The content requirements are detailed but the following points, in particular, are worth noting:

- There is an overriding requirement that the KID be accurate, fair, clear and not misleading.

³ http://ec.europa.eu/internal_market/consultations/docs/2010/priips/consultation_paper_en.pdf.

- The KID must be in a clear type and colour and in an official language of the member state where it is sold (or a language otherwise accepted by its competitive authority).
- The KID must be a stand-alone document, clearly separate from marketing materials. There had been some debate in the previous consultation papers as to whether the KID should be a stand-alone document or designed to be used in conjunction with an offering or similar document. The Commission justifies the stand-alone requirement on the grounds that it believes retail investors should not be required to read other documents to be able to understand the key features of the investment product. This requirement will, however, clearly present a challenge for product manufacturers, particularly in relation to more complex products. It may also make investors even less inclined than they do currently to review any prospectus that is produced in relation to the product.
- The KID should be short (although the Regulation does not include a specific length limit) and be drafted in clear, succinct and comprehensible language that avoids the use of jargon and technical terms where possible.
- The Regulation contains considerable prescriptive requirements as to the form of the KID. It must have the title “Key Information Document” at the top of the first page, together with an explanatory statement which must follow the language set out in the Regulation. The KID must also include the following sections:
 - The name of the investment product and the identity of the product manufacturer
 - A section titled “What is this investment?” setting out the nature and features of the investment, including the type of product, its objectives and the means for achieving them, details of any insurance benefits and the term of the product (if known). Where applicable, performance scenarios should also be provided
 - A section titled “Could I lose money?” giving an indication of whether loss of capital is possible, including a description of any guarantees or capital protection (and any limitations to these) and whether the investment product is covered by a compensation or guarantee scheme
 - A section titled “What is it for?” indicating the recommended minimum holding period and the expected liquidity profile of the product, including the terms on which it can be unwound prior to maturity with regard to the risk and reward profile of the product
 - A section titled “What are the risks and what might I get back?” setting out the risk and reward profile of the product and a summary indicator of this profile and specific risks not reflected in such indicator
 - A section titled “What are the costs?” setting out the costs associated with an investment in the product (both direct and indirect) and summary indicators of these costs
 - A section titled “How has it done in the past?” setting out, where relevant, the past performance of the product with regard to its nature and the length of its track record
 - For pension products, a section titled “What might I get when I retire?” giving projections of possible future outcomes

No further information is permitted to be provided in the KID, except where it necessary for the retail investor to make an informed investment decision about a specific investment product. The Commission has made it clear that all KIDs should have a standardised look and feel in order to promote comparability of information and easy comprehension by retail investors. The Regulation therefore provides that the KID, shall be presented in a common format with the same headings and in the order set out above. Further detail as to the required presentation and content of the KID, will be provided by the Commission in delegated acts. Although it has been stated that the

Commission shall take into account the differences between investment products and their particular features, it seems that a prescriptive approach is inevitable, which will be particularly challenging for manufacturers of more complex products. The European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority are also required to develop draft regulatory standards to determine the methodology for the risk and reward section of the KID, and the calculation of costs in relation to the costs section. Such standards are required to take into account the different types of investment products and the Commission has previously acknowledged there are significant challenges in this regard, bearing in mind the very different cost structures between, for example, a structured security and a funds product.

The Commission had previously indicated that, as with the key investor information disclosure requirements under the UCITS IV Directive ("KIID")⁴, a simple risk indicator of between 1 and 7 should be specified in the KID in relation to the relevant product. The draft legislation still provides that a summary indicator must be included in the risk section as to relevant risks and warnings in relation to any specific risks that may not be fully reflected in the summary indicator. It does not, however, include a requirement that the summary indicator be a number between 1 and 7, although implementing legislation could still seek to impose such a requirement. There had been concerns that a simple indicator would give an oversimplified measure of risk for a complex product and give rise to a risk of over-reliance on the indicator by investors.

There is some dismay among market participants that the PRIPs KID requirements are additional to the requirement in recent amendments to the Prospectus Directive⁵ for an issue-specific summary for retail offerings of securities. Although the EU Commission had previously indicated that requirements for an issue-specific summary could be combined with the KID requirement, it acknowledges in the Explanatory Memorandum to the PRIPs proposals that the two requirements are different and cannot be achieved by the same document. Issuers of structured securities issued to retail investors pursuant to a Prospectus Directive compliant prospectus will therefore have to ensure that both a KID and final terms summary is produced. This seems to run counter to the objective of providing a more level playing field between different types of product. It also seems perverse (and confusing) that investors will receive two different types of summary both intended to set out key features and risks of the product.

In view of the fact that UCITS KIID requirements have only recently come into force, the Commission is proposing transitional provisions that will permit UCITS funds to continue to comply with the UCITS KIID requirements for five years after the PRIPs legislation comes into force. In view of the prescriptive requirements under UCITS IV, this may not make much difference in practice and it is possible that some UCITS funds may elect to comply with the new PRIPs regime during the transition period.

The Regulation provides that the product manufacturer must review KID regularly. In this regard, the Commission has the power to adopt delegated acts setting out detailed rules for the conditions and frequency of the review and circumstances in which retail investors are to be informed about a revised key information document for an investment product purchased by them.

If a retail investor can show the KID does not comply with the terms of the Regulation, it can claim damages for losses suffered as a result of its reliance on the KID. In this case, the burden of proof is on the product manufacturer to show its KID complies with the content requirements of the Regulation. However, it would appear (though this is not specified expressly) that the investor would still have the burden of proof to show the losses suffered as a result of reliance on information in the KID.

The reversal of the burden of proof for showing that a KID complies with the Regulation had not been proposed in the Commission's previous consultation and will require some careful analysis by product manufacturers in preparing their KIDs.

⁴ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF>.

⁵ Commission Delegated Regulation (EU) No 486/2012, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:150:0001:0065:EN:PDF>.

Provision of the KID to Retail Investors

Product distributors are required to provide retail investors with its KID free of charge and “in good time” before they purchase the product; a limited exception applies if the retail investor has chosen to conclude the transaction by means of distance communication where prior distribution of the KID was not possible and who has been informed of this fact by the distributor. There is not, however, a need to provide the KID again to the same investor when it enters into a subsequent investment in a product it has previously purchased based on the KID. The Commission is expected to publish delegated acts specifying further details as to how the KID is to be delivered to investors, including guidance on the meaning of “in good time”. The KID must be produced on paper or another durable medium, or by way of website, in a way that meets the conditions specified in the Regulation, including that the investor has consented to the provision of the KID by website and has been notified electronically of where to access the document on the web.

The product manufacturer is also required to establish procedures and arrangements to ensure that retail investors who have submitted a complaint in relation to the KID receive a substantive reply in a “timely and proper manner”. The Regulation also requires the product manufacturer and/or distributor to participate in any alternative dispute resolution commenced by the investor, subject to certain conditions. Member states are also required to establish “effective, proportionate and dissuasive” sanctions to be applied where the terms of the Regulation are breached. In this regard, competent authorities in different member states are required to cooperate to avoid duplication and overlap in cross-border cases.

Next Steps

The draft legislation will now be subject to a trialogue of discussions between the Commission, the EU Council and the EU Parliament. The current goal of the Commission is for implementation of the proposals by the end of 2014.

Conclusions

The draft legislation is largely consistent with the Commission’s previous consultation paper so there are no huge surprises in its proposals, other than the “reversal” of the normal burden of proof as to whether the content of the KID complies with the Regulation or not. Concerns will remain, however, that the KID requirements are already prescriptive and likely to be more so once implementing legislation is published. Although there are clear advantages to having descriptions of products aimed at retail investors set out in a consistent way, an overly-prescriptive approach is likely to increase administrative costs to the detriment of investors, without necessarily aiding comparability across different sectors. There is also a concern among many market participants that the combination of the PRIPs proposals with other regulatory developments, including MiFID II, is likely to discourage issuers and investors away from complex products. This will be welcomed by some who regard complexity as one of the causes of the financial crisis, but a kneejerk reaction away from products simply because of their complexity is, however, misconceived and will decrease investor choice and lead to less efficient markets. What is important is that investors are provided with the information necessary to understand the fundamental risks and rewards involved with the products they are buying.

Authors

Peter Green
4420 7920 4013
pgreen@mofo.com

Jeremy Jennings-Mares
4420 7920 4072
jjenningsmares@mofo.com

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>.

Morrison & Foerster named **Best Law Firm of the Americas, 2012** by *StructuredRetailProducts.com*.

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life science companies. We've been included on *The American Lawyer's* A-List for nine straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com. © 2012 Morrison & Foerster LLP. All rights reserved.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.