

# Structured Thoughts

*News for the financial services community.*



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## Opinions and Warnings – ESMA's Views on Complex Products

The European Securities and Markets Authority (ESMA) finally published its views on the regulation of structured products on 7 February 2014, focusing in particular on selling practices relating to “complex” investments. Accepting that EU regulatory requirements in this area (as set out in the Markets in Financial Instruments Directive (MiFID<sup>1</sup>)) should already “be sufficient, if correctly applied, supervised and enforced,”<sup>2</sup> ESMA felt it necessary to provide a detailed opinion (the “Opinion”)<sup>3</sup> to national competent authorities (NCAs), serving as both a reminder of their existing duties and obligations when regulating the marketing and sale of complex products under MiFID, as well as providing additional color with respect to the approach that should be taken in order to ensure compliance. The existing approach under MiFID, it feels, is the right one. The execution, however, is lacking—particularly with respect to the conduct of business rules, such as information to clients, suitability and appropriateness. Accordingly, the intention is to find some “common ground where possible for distribution frameworks of complex structured products across the Union”.<sup>4</sup>

Alongside the Opinion, ESMA has also published a shorter document for the benefit of market participants, specifically addressing the risks of investing in complex products (the “Risk Warning”)<sup>5</sup>. The Risk Warning sets out (in limited detail), some of the principal risks that are inherent in investing in complex products (liquidity, leverage, market and credit risk), as well as details pertaining to the types of products that such investment risks apply. The principal features of both the Opinion and the Risk Warning are explored further below.

<sup>1</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

<sup>2</sup> See the Opinion (referenced below) at paragraph 6.

<sup>3</sup> [http://www.esma.europa.eu/system/files/ipisc\\_complex\\_products\\_-\\_opinion\\_20140105.pdf](http://www.esma.europa.eu/system/files/ipisc_complex_products_-_opinion_20140105.pdf).

<sup>4</sup> Steven Maijor, Chair of ESMA—ESMA Investor Day: 12 December 2012, Paris (<http://www.esma.europa.eu/system/files/2012-818.pdf>).

<sup>5</sup> [http://www.esma.europa.eu/system/files/investor\\_warning\\_-\\_complex\\_products\\_20140207\\_-\\_en\\_0.pdf](http://www.esma.europa.eu/system/files/investor_warning_-_complex_products_20140207_-_en_0.pdf).

## Complex Products

MiFID does not specify in detail precisely what constitutes a “complex product” (although it does define “non-complex” products)<sup>6</sup>. ESMA considers that everything that is not non-complex should be regarded as complex, and it has decided to set out some detailed examples of complex products and product types. Specifically, these include products that:

- are derivatives or contain embedded derivatives;
- are made up of one or more underlying financial instruments that are difficult to value or have been structured in a way that makes it difficult to assess the risks involved and the likely performance scenarios;
- incorporate opaque (i.e., non-market-standard) indices;
- effectively lock investors in for a fixed period (without adequately explaining the exit barriers);
- are subject to complex pay-off formulae (potentially including multiple variables); and/or
- contain conditional or partial capital protection rights (including where such rights can be withdrawn).

The Opinion further develops its definition, by listing some specific examples of products that it believes should be considered complex. These include, amongst others, contracts for differences, convertible or exchangeable bonds, warrants, certificates, certain types of derivatives, credit-linked notes and asset-backed securities. In fact, ESMA’s view is that “*the vast majority of structured products*” can be considered to be complex.

## Organization and Controls

ESMA sets out a number of requirements in the Opinion relating to the internal controls and processes of firms when developing and selling complex products. NCAs are required to (among other things) monitor relevant internal controls (including any trading platforms that give access to complex products), ensure that firms do not offer advice with respect to products that are not in their client’s best interests, and ensure that relevant staff (including those establishing a product’s target market and assessing the needs and circumstances of clients) are adequately trained and have a detailed understanding of the workings and nature of relevant products and financial markets.

In addition to the above, ESMA requires that NCAs ensure that firms assess whether the complex product should be sold on an advised or non-advised basis to their target clients. Sales of complex products on a non-advised basis should be monitored to ensure that any categorization of clients is robust and correctly reflects the status of each client. Any such assessment should also take into account any identified conflicts of interest (which must be managed appropriately).

## Suitability and Appropriateness

MiFID already requires that, when providing investment advice, firms obtain all necessary information with respect to a client’s knowledge and experience, financial situation and investment objectives, in order to recommend particular services or financial instruments which are suitable.<sup>7</sup> However, in July 2012, ESMA published its “*Guidelines on certain aspects of the suitability requirements*,”<sup>8</sup> which stated that investment firms should consider whether they require additional (more in-depth) information from clients when dealing with complex instruments. The Opinion further develops this requirement by providing that NCAs should monitor the additional information required, ensuring that it is sufficient for the purpose of establishing:

1. the client’s objectives and attitude to risk (in particular, in relation to investments that involve leverage and those linked to highly volatile asset classes);

<sup>6</sup> Directive 2004/39/EC at Article 19(6) and Article 38 of Directive 2006/73/EC (the MiFID Implementing Directive).

<sup>7</sup> Directive 2004/39/EC at Article 19(4). Also see Article 35 of Directive 2006/73/EC.

<sup>8</sup> <http://www.esma.europa.eu/system/files/2012-387.pdf>.

2. any time horizons for the investment (taking a possible lack of liquidity into account);
3. whether the client will have sufficient funds to cover reasonably foreseeable future commitments and comfortably afford possible losses (taking into account the amount of capital loss exposure);
4. the client's awareness of charges, risks and costs relating to a product and the way in which these variables might impact return; and
5. the depth of a retail client's knowledge and experience (this should include looking at prior transaction experience). Although this is already required under MiFID<sup>9</sup>, ESMA's view is that firms should not over-rely on a client's self-assessment and NCAs must ensure firms have policies and procedures in place to check that client information is accurate and up to date. This requirement applies with respect to tests for both suitability and appropriateness.

When assessing appropriateness, MiFID already requires that, where a firm determines that a product is not appropriate for a client, it must warn the client; and where the client does not provide sufficient information to assess his or her knowledge and experience, it requires the firm to warn the client that it will not be able to make an appropriateness determination. ESMA requires NCAs to carefully monitor the internal controls and processes of firms that have high numbers of clients that fall into this latter category.

### Disclosure

ESMA is concerned about ensuring that all clients are fully aware of the total costs and charges applicable to each complex product. As a consequence, the Opinion requires that NCAs encourage firms to disclose cash values (even example ones), as well as the relative impact that charges may have on future performance. Firms should also disclose any potential consequences for seeking to sell or exit earlier than originally planned. This requires an explanation of how long clients need to hold their investment. In addition, clients should be made aware of circumstances where an early withdrawal may result in return of an amount less than the principal invested as a result of charges being applied.

The Opinion also gives guidance with respect to the application of MiFID's "*fair, clear and not misleading*"<sup>10</sup> principle:

1. the realistic likelihood of receiving headline (maximum) returns should be clearly explained and not be the primary feature of any communication;
2. jargon and technical terms should be avoided (such as "absolute" or "hedged"); and
3. national investor compensation schemes (and whether they do or do not apply) should be highlighted.

In addition, product offerings for complex products should be very clear when setting out any details relating to capital protection (including the extent to which it applies). They should also highlight the impact of any leveraging or embedded derivatives and explain the functioning and legal effect of any product "wrappers".

### Monitoring and Execution

The Opinion provides some further guidance with respect to ongoing risk assessment by NCAs. ESMA's view is that the greater the complexity of the product, the greater the scrutiny of the firm's compliance function should be. Finally, ESMA also requires that a firm's choice of execution venues (for the purchase and sale of complex products) and the application of its best execution policy be carefully monitored.

<sup>9</sup> See Article 37 of Directive 2006/73/EC.

<sup>10</sup> Directive 2004/39/EC at Article 19(2).

## Risk Warning

As referred to above, on 7 February 2014, ESMA also published a Risk Warning to complement the guidance provided in its Opinion. Unlike the latter document, which provides guidance to NDAs, the Risk Warning is intended to be reviewed by market participants who are considering investing in complex products. In summary, the Risk Warning:

- highlights certain “Key Messages,” including the need to understand the key features of the products being sold (and recommendation to obtain legal advice where necessary), to be aware of market terminology that may be misleading, to consider the ability to trade in and out of the product and to understand what the total costs are;
- defines “complex” products in a fashion similar to that set out in the Opinion;
- sets out certain key risks and disadvantages of investing in complex products—including liquidity risk (inability to sell the product, at least without incurring a significant loss, before the end of its term), leverage risk (the possibility that losses can be multiplied), market risk (complex products often expose an investor to one or more underlying markets) and credit risk (the inability of the product issuer to meet its contractual obligations should always be taken into account); and
- refers to the importance of being aware of product costs, which are often higher with respect to complex products (since investors are paying for the underlying features of the investment).

It is worth noting, however, that there is no requirement for the Risk Warning to be provided directly from issuers to potential investors. Its effectiveness, therefore, appears to be seriously limited, since it is not immediately obvious how ESMA or NCAs will ensure that the Risk Warning will be seen by the retail investors whom they are most focused on protecting.

## Relationship with Other EU Initiatives

Although this is the first time that ESMA has published its views with respect to complex products generally (and not just suitability issues), its Opinion should also be viewed in the context of a host of similar initiatives at EU Member State, EU and global levels. The PRIIPS initiative in the EU, for example, focuses heavily on the marketing and sale of certain investment products (those involving an indirect exposure to underlying assets) to retail investors. In some individual EU Member States, the complexity of certain investment products, among other things, dictates whether or not more stringent product regulations will apply. Other initiatives may also arise, perhaps on a more sectoral basis, as a result of recent harmonized European principles for the oversight of financial products development.<sup>11</sup> As outlined above, ESMA’s Opinion is directed specifically towards NCAs (not individual firms) and is intended only to assist and provide color with respect to ensuring compliance with MiFID as it already exists today.

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## SEC Releases Draft Strategic Plan

On February 3, the SEC released a draft 2014-2018 Strategic Plan. The draft sets forth the SEC’s mission, vision, values, strategic goals, planned initiatives and performance goals for the years ahead. While the Strategic Plan has a broad focus and is subject to change, there are a few items of interest for readers of this publication.

The SEC’s Strategic Objective 1.2 is to promote “capital markets that operate in a fair, efficient, transparent, and competitive manner, fostering capital formation and innovation.” As part of this objective, the SEC plans to implement initiatives that include enhancing the oversight of derivatives by working with the CFTC and foreign regulators, and considering streamlining the process for introducing new exchange-traded funds (ETFs) by allowing certain ETFs to be introduced to the market without the need for an exemptive order.

<sup>11</sup> <http://www.mofo.com/files/Uploads/Images/131202-European-Oversight-Financial-Products.pdf>.

Strategic Objective 3.1 is to work “to ensure that investors have access to high-quality disclosure materials that facilitate informed investment decision-making.” The SEC plans to design and implement new disclosure regimes for certain specialized categories of issuers so that investors in these products have relevant and useful information with which to make informed investment decisions. These changes would include enhanced disclosure requirements for “securitized products and other complex financial instruments,” as well as variable annuities and target date retirement funds.

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## Distributing Structured Notes from a Regulation S Platform

### Introduction

In recent years, structured products sales have grown in a wide variety of non-U.S. jurisdictions. Many of these include countries in the U.S.’s backyard, such as Central America and South America, while others are more distant.

U.S.-based structured note desks, for both U.S. and non-U.S. issuers, are increasingly involved in the sales of products to investors in these jurisdictions. These U.S. desks often have the most useful institutional infrastructure and knowledge base within a banking organization to handle these offerings. Depending on investor preference and other factors, many of these offerings are effected from an issuer’s Regulation S program, as opposed to a U.S. registered shelf or exempt bank note program.

As an increasing number of U.S. broker-dealers begin to participate in these types of offerings, we have prepared this article, which summarizes a variety of issues for U.S. broker-dealers to consider as they begin to participate in these programs.

### Who Exactly Is the Issuer?

Most structured note issuers are part of an international financial institution, which may issue notes in different parts of the world through different entities, including one or more funding vehicles. Some financial institutions may have more than one Regulation S program, and sometimes more than one Regulation S program that provides for the issuance of structured notes. Accordingly, the broker should determine at an early stage which corporate entity is the issuer. The broker will need to confirm that its due diligence procedures are appropriate as to that entity. To the extent the broker is receiving periodic deliverables, such as comfort letters and/or legal opinions, the broker will wish to ensure that it is receiving them for the correct issuer and program.

### What Regulation S Requirements Apply?

A full discussion of Regulation S’s requirements is beyond the scope of this article.<sup>12</sup> However, we would note that a key question for any Regulation S offering is which Regulation S category the relevant issuer falls into. Of the three categories, “Category 1” imposes the fewest requirements, “Category 3” imposes the most requirements and (surprise) “Category 2” falls between the two. Most structured note programs discussed in this article fit within Category 2 or Category 3.

The relevant category has a number of results, including certain legending requirements in the offering documentation, the form of the notes that must be used to evidence the transaction, and certain substantive provisions that must be included in any agreements with the distributors of the notes. These provisions are found in Rule 903 of Regulation S, and counsel will need to know the correct category in order to properly document the transaction.

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<sup>12</sup> For a summary of Regulation S, please see our publication, “Frequently Asked Questions About Regulation S,” which may be found at: <http://www.mofo.com/files/Uploads/Images/FAQs-Regulation-S.pdf>.

## Scope of Disclosures

As compared to SEC-registered offerings, the offering documents for Regulation S structured notes have fewer prescribed form requirements. (Of course, for liability purposes, the documents cannot contain any material misstatement or omission of a material fact.)

That being said, a broker may seek to conform the content of the disclosures, and some of the presentation, to that of its registered notes. For example, some investors may purchase (and some distributors may distribute) notes with similar terms from both channels, and may wish to see comparable disclosures, including the relevant risk factors and the presentation of hypothetical examples and/or historic performance information. Making the disclosure comparable can facilitate an investor's understanding and evaluation of the product. In order to avoid any timing issues, the form and content of the disclosures should be agreed upon as early as possible with the relevant parties.

## Stock Exchange Listing

Most EMTN programs are listed on one or more European or other stock exchanges, such as the London Stock Exchange. Where the program is listed on a regulated market in the EU, the issuer must deliver a prospectus in compliance with the European Union's Prospectus Directive requirements. However, the issuances of structured notes that are offered by U.S. broker-dealers, particularly when they are made on a reverse inquiry basis, are often not independently listed. This is particularly relevant in the case of issuances to European investors, even if issued under a program that is listed on a regulated market in the EU. This is because, unless all principal terms and risk factors relating to the particular structured note issuance and matters requiring inclusion in the prospectus under the Prospectus Directive are already included in the base prospectus, the structured notes are not permitted to be listed unless issued under a new Prospectus Directive-compliant prospectus or unless the existing program is amended, either of which will require approval by the relevant competent authority. This step would be a "speed bump" for any proposed offering.

Accordingly, if there is a plan to list the relevant issuance on a regulated market in the EU, advance planning should be made to ensure the completion of the relevant documentation.

## Distribution Agreements

A U.S. broker may be party to a program or similar agreement with an issuer for U.S.-registered structured notes, and may be party to selling group agreements with downstream dealers for sales of those products. However, those existing agreements, whether based on SIFMA model forms or otherwise, will typically not contemplate Regulation S sales.

Accordingly, the relevant entities will wish to make sure that appropriate Regulation S-compliant agreements are in place between the relevant parties to the distribution. The section above, "What Regulation S Requirements Apply?," which discusses the differences between different categories, is relevant here, as the relevant Regulation S provisions impose different substantive requirements. For example, in Category 2 and Category 3 offerings, distributors selling to other dealers during the so-called "40-day distribution compliance period" must send a confirmation or other notice to the purchaser stating that the purchaser is subject to the same Regulation S restrictions on offers and sales that apply to a distributor.

## Determining the End of the Distribution Compliance Period

For debt securities in "Category 2" of Regulation S, such as most structured notes, distributors cannot sell the notes into the U.S. in secondary sales until the end of a 40-day "distribution compliance period." This period typically begins when the initial offering has been completed. In syndicated offerings, this date can be hard to pin down, as one or more distributors may not have sold their full allocation on the pricing date, and may hold some of the offered securities included in their accounts. However, for structured notes sold in Regulation S offerings, this is typically not an issue. In these types of offerings, the size of the offering is usually expected to match the amount of orders placed. Distributors will need to make one another aware if this is not the case, and if the initial offering has in fact not been completed at the time of the pricing.

## FINRA Offering Communication Rules

If a U.S. broker is participating in the offering, attention must be paid to the relevant FINRA rules, including FINRA's new communication rules, which became effective in February 2013. If any term sheet or other document prepared by a FINRA member constitutes a "retail communication" (distributed to 25 or more "retail investors"), it will be subject to FINRA's approval, content and retention requirements.<sup>13</sup>

## Bearer vs. Registered Form and TEFRA D

Some Regulation S programs provide for notes issued in bearer form for U.S. federal tax purposes, and some programs provide for notes in "registered form." Other programs provide for both, and the form will vary from issuance to issuance.

The U.S. Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") imposes certain restrictions on the issuance and ownership of bearer debt securities. TEFRA was designed to promote the issuance of debt securities in the U.S. market in registered form, so that U.S. tax authorities can trace ownership of the securities and determine whether holders of those securities have paid their U.S. taxes on related income and gain. While the TEFRA rules do not explicitly prohibit an issuer from issuing a bearer debt security to a U.S. person or prohibit a U.S. person from holding a bearer debt security, they impose stiff penalties on those issuers and holders. As a result, U.S. and foreign issuers must consider TEFRA implications in offerings of bearer debt made in reliance on Regulation S.

The TEFRA rules provide the following sanctions against any issuer of certain securities in bearer form:

- denial of a deduction for interest payments on these obligations; and
- imposition of an excise tax equal to 1% of the product of the principal amount of the obligation and the number of calendar years (or fraction of a year) during the period from the issue date to maturity.

A U.S. taxpayer holding such a security in bearer form may be subject to the following sanctions:

- denial of a deduction for losses incurred on these obligations; and
- treatment of gains resulting from the sale or exchange of such obligations as ordinary income.

In addition, the portfolio interest exemption is not available to shield interest payments with respect to bearer debt obligations from U.S. withholding tax if the obligations are issued in violation of the TEFRA rules. Although in form this sanction appears to be a holder sanction (because the burden of the withholding tax falls on the holder), it may instead impact the issuer if the issuer is subject to an obligation to gross-up the holder for any withholding taxes, or is determined to be liable for taxes it failed to withhold.

Regulations under TEFRA (the "TEFRA C" and "TEFRA D" regulations) identify the kinds of arrangements that are reasonably designed to ensure that bearer securities will be sold (or resold in connection with the original issue) only to a person who is not a U.S. person. These rules operate independently of Regulation S, and compliance with Regulation S will not ensure compliance with TEFRA.

On March 18, 2010, the U.S. Hiring Incentives to Restore Employment Act (the "HIRE Act") was signed into law. With respect to debt obligations issued after March 18, 2012, the HIRE Act repeals the exemption from the TEFRA sanctions. As a result, any issuer of certain bearer securities will be denied an interest deduction. In addition, interest payments on such obligations will no longer qualify for the portfolio interest exemption, thereby subjecting such interest to a 30% U.S. withholding tax.

The HIRE Act preserves the exception to the excise tax for securities that are issued under TEFRA-compliant procedures. As a result, foreign issuers of a "foreign-to-foreign" bearer debt offering that is TEFRA-compliant would not be subject to the excise tax.

<sup>13</sup> For a summary of these provisions, please see our article "FINRA Announces Effective Date of New Rules re Communications with the Public," which may be found at the following link: <http://www.mofo.com/files/Uploads/Images/120621-Structured-Thoughts.pdf>.

## Non-U.S. Selling Restrictions?

Until this point, we have focused on U.S. and European regulations. However, depending upon the countries in which the notes are sold, a variety of additional non-U.S. and non-European legal provisions may apply to the offering. In particular, depending upon the countries in which the notes will be offered, a variety of selling restrictions may be required (or advisable) under applicable law. In some jurisdictions, the relevant private placement regime may not offer as clear a safe harbor as, for example, U.S. Regulation D or U.S. Rule 144A. Accordingly, brokers may wish to obtain advice from local counsel prior to offering in a new jurisdiction.

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## Non-U.S. Equity Underliers and Exchange Rate Risks

### Introduction

Market participants and investors are accustomed to finding risk factors about exchange rates when the underlying asset is a non-U.S. index, or a U.S. ETF that tracks non-U.S. stocks. However, the nature of the risks can differ, depending upon the nature of the underlier. Accordingly, some care is advisable in adapting risk factors from one offering document to another. In this article, we will describe in more detail these differences.

### Index with Stock Prices Converted into Dollars

Some non-U.S. indices incorporate a mechanism that converts the non-U.S. prices into U.S. dollars, often on each trading day. As a result, the index itself creates exchange-rate risk for the investor. If the U.S. dollar increases in value against the relevant non-U.S. currencies, the non-U.S. currencies are exchangeable for fewer U.S. dollars. As a result, the level of the index, and therefore the return on notes that track the index, will be lower than it would have been had the deemed currency conversion not taken place.

A similar circumstance exists when the index itself does not have a mechanism to convert the index level to dollars, but instead, under the terms of the notes, the calculation agent adjusts the final index level to reflect the relevant exchange rate. For example, the EURO STOXX 50 Index may be calculated in euros, but the terms of the note may require the initial index level and the final index level to be converted into dollars, based upon the then current U.S. dollar/euro exchange rate. For these types of notes, investors face a similar type of currency risk. If the U.S. dollar appreciates against the relevant non-U.S. currency between the pricing date and the valuation date, the converted index level will be lower, as fewer U.S. dollars may be purchased by each unit of the relevant non-U.S. currency.

### Index Without Prices Converted into Dollars

Some non-U.S. indices do not have the type of currency conversion feature described in the preceding section. In the case of an index of this kind, the investor faces the risk that it will miss out on the benefit that would have occurred if the relevant non-U.S. currencies had appreciated against the U.S. dollar. For example, if an investor had actually purchased the non-U.S. stocks, and later sold them, converting the proceeds back into U.S. dollars, he or she would have realized a benefit by receiving additional U.S. dollars at the time of sale. In this sense, by investing in the index-linked notes, as opposed to investing in the actual underlying stocks, the investor loses the opportunity to participate in any appreciation of the non-U.S. currency.

### ETFs That Invest in Non-U.S. Stocks

An ETF may purchase non-U.S. stocks that are denominated in currencies other than the U.S. dollar. When the ETF's net asset value is calculated, the price of the stocks held by the ETF will typically be adjusted to reflect their U.S. dollar value by converting their price from the non-U.S. dollar currency to U.S. dollars. As a result, if the value of the U.S. dollar strengthens against the relevant non-U.S. dollar currency, the price of the ETF may decrease even if the market price of the relevant stock increases in its own currency.

## A Few General Risks Relating to Currencies

As to any non-U.S. index or ETF, currency exchange rate changes may have a variety of different effects, which may not necessarily be quantifiable or predicted. For example, if a non-U.S. currency appreciates in value against the dollar, the relevant country's exports may be adversely affected, as they become more expensive for outsiders to purchase. Of course, this could reduce the level of any non-U.S. index. However, this result isn't guaranteed. A more valuable currency can increase consumption levels in a particular country, which may increase the values of the relevant index. These types of general risks are often addressed in a "generic" risk factor relating to the effects of investing in non-U.S. indices or ETFs.

## Currency Risks Unique to a Particular Index or ETF

Some indices and ETFs may have their own unique currency risks. For example, the index or ETF may involve a currency hedging strategy, in addition to tracking the relevant non-U.S. stocks. Other indices may invest in stocks that, by their nature (or design), may have additional exposure to currency risks, such as financial institutions and export-oriented companies. In each of these cases, the offering documents may need to be carefully reviewed to ensure that the applicable risks are appropriately described.

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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 eight years. See the write-up at <http://www.mofo.com/files/Uploads/Images/120530-Americas-Awards.pdf>.

Morrison & Foerster named **Best Law Firm in the Americas, 2012, 2013** by *StructuredRetailProducts.com*.

Morrison & Foerster named **Legal Leader, 2013** by *mti-i* at their Americas Awards. Two of our 2012 transactions were also granted awards of their own as a result of their innovation.

Morrison & Foerster named **European Law Firm of the Year, 2013** by *Derivatives Week* at their Global Derivatives Awards.

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