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Structured Thoughts

News for the financial services community.

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FCA Publishes Thematic Review on Structured Product Development and Governance

On 5 March 2015, the UK's Financial Conduct Authority ("FCA") published a thematic review on product development and governance in relation to structured products.[1]

The FCA states that its review is part of its ongoing examination of how firms in retail and wholesale markets are developing new structured products in the light of the finalised guidance for structured products published by the Financial Services Authority ("FSA"), the FCA's predecessor, in March 2012.[2] The review focuses in particular on the FCA's objective that firms treat their customers fairly and have appropriate arrangements and safeguards in place in relation to product development and governance, to enable them to meet their requirements in this regard. The FCA stresses, in particular, that firms should:

- identify the target market and design products that meet the needs of end customers in that target market;
- stress-test new products to ensure they are capable of delivering fair outcomes for the target market of end customers;
- have a robust product approval process for new products;
- provide appropriate information to distributors and end customers; and

[1] http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr15-02
[2] http://www.fca.org.uk/static/pubs/guidance/fg12-09.pdf

- monitor the progress of a product through to the end of its life cycle.

The FCA's review included research relating to retail customers buying structured products, looking at whether they were making informed product choices. It also engaged in detailed supervisory assessments with a number of retail and wholesale firms involved in manufacture and distribution. The FCA concluded that retail customers continue to struggle to understand complex features common to many structured products and often overestimate their potential returns. It also concluded that many firms manufacturing and distributing structured products are not sufficiently following the previous FSA guidance and, in particular, (a) are not defining a clear target market at the product design stage, (b) are not conducting sufficiently robust analysis and stress testing and (c) are not properly assessing whether products are likely to represent value for money for end customers. In addition, the FCA is concerned that some manufacturers are failing to monitor how products are distributed and whether distributors have sufficient information about the product and the target market to meet their own obligations to the end customer.

The FCA specifies six key messages arising out of its work:

- retail customers generally struggle to understand the relative merits of structured products and the factors driving potential returns. Firms should take steps to bridge this knowledge gap;
- firms' senior management must do more to put customers at the forefront of their approach to product governance – this should begin with the identification of a clear target market during product design;
- structured products should have a reasonable prospect of delivering economic value to customers in the target market. Firms should use stress testing as part of the product approval process to help meet this objective;
- firms should provide customers with clear and balanced information on each product and any risks;
- manufacturers should strengthen the monitoring of their products, including ensuring distributors have enough information about the product to sell it appropriately and checking that each product is being distributed to its target market;
- firms should do more to ensure fair treatment of customers throughout the lifecycle of a structured product.

The FCA's focus on product development and governance is consistent with an increased EU regulatory focus in this area under the recast Markets in Financial Instruments Directive ("MiFID II") and the Regulation relating to Packaged Retail and Insurance-based Investment Products ("PRIIPs"). The FCA notes that these regulations will impose more detailed requirements on firms manufacturing and distributing structured products to retail customers. The FCA states that all the firms it assessed as part of the thematic review will be asked to explain how they will ensure the fair treatment of customers for the new structured products they bring to market. This may include remediation work by some firms and could lead to redress for some customers. The FCA also indicates that if necessary, it will consider the use of other regulatory tools, including by using its product intervention powers.

EU Commission Review of Prospectus Directive

On 18 February 2015, the European Commission issued a consultation paper relating to its broad-ranging review of the EU Prospectus Directive. The consultation lasts until 13 May 2015 and will be of interest to anyone proposing to offer or list securities in Europe, but certain categories of the consultation are relevant particularly to structured note issuances.

The consultation asks a number of questions related to when a prospectus should be required and when an exemption should apply. These include the automatic exemption for higher denomination securities (at least EUR 100,000) from producing a prospectus for a public offering, and the lighter disclosure regime for such securities where a prospectus has to be drawn up for a listing on an EU regulated market. It also considers whether there should be a harmonised approach across the EU to the question of prospectuses for small offerings (below EUR 5 million). The current position is that the

Prospectus Directive does not mandate a prospectus for such an offering, but leaves it open to each EU member state as to whether to impose any prospectus requirements.

The consultation then moves on to focus on the content of prospectuses. Of particular interest here for structured note issuers are the questions regarding short form disclosure. When the PRIIPS Regulation comes into force in the EU, for a structured note sold to a European retail investor, there will be a need to provide a short Key Investor Document (KID) summarising the essential features of the product. This will be in addition to the separate prospectus summary that is already required under the Prospectus Directive in relation to debt securities with denominations below EUR 100,000. The European Commission acknowledges that there is a large degree of overlap in the information required for these two documents and asks for views as to how the overlap of information should best be addressed, whether by means of information already contained in the KID not being duplicated in the prospectus summary, or by eliminating the need for a prospectus summary for such securities altogether. Another alternative approach put forward is whether the formatting content of the prospectus summary and the PRIIPS KID should be aligned, in order to minimise costs and promote comparability of products. These acknowledgements and focus on the overlapping content should be welcomed by structured note issuers.

The European Commission also asks whether there would be support for introducing a maximum length for a prospectus or for certain specific sections of the prospectus, and this could be particularly relevant to structured securities programmes where the base prospectuses are typically some of the longest prospectuses that need to be approved by competent authorities. It also asks for views on whether base prospectuses should be able to remain valid for takedowns for more than the current one year period.[3]

For further detail on the points covered by the consultation, please see our separate publication "A European Prospectus Revolution?".[4] For further details of the PRIIPS Regulation in Europe, please see Structured Thoughts Volume 5, Issue 4.[5]

SEC Issues Investor Bulletin Relating to Structured Notes

In January 2015, the SEC's Office of Investor Education and Advocacy issued an investor bulletin relating to structured notes. The alert may be found at the following link: http://www.sec.gov/oiea/investor-alerts-bulletins/ib_structurednotes.html.

The bulletin describes various types of common structured notes, and highlights several key risk factors that are commonly associated with this product class. The bulletin also identifies a variety of recommended questions that investors should ask, prior to investing in these products.

In some respects, the bulletin builds on prior SEC alerts, including:

- The SEC and FINRA's joint 2011 alert, "Structured Notes with Principal Protection: Note the Terms of Your Investment[6]"; and
- "Equity-Linked CDs.[7]"

In addition, the bulletin builds on some of the themes raised in the SEC's 2012 "sweep letter":

[3] For example, in the U.S., "shelf registration statements" remain effective for at least three years.
[4] Available at http://www.mofo.com/~/media/Files/ClientAlert/2015/02/150223AEuropeanProspectusRevolution.pdf
[5] Available at http://www.mofo.com/~/media/Files/Newsletter/140602StructuredThoughts.pdf
[6] Available at: http://www.sec.gov/investor/alerts/structurednotes.htm
[7] Available at: http://www.sec.gov/answers/equitylinkedcds.htm

- The bulletin describes structured notes as an instrument with two components: a bond component and an embedded derivative.
- The bulletin notes to investors that the purchase price of a structured note is likely to be higher than the instrument's fair value on the issue date.

The bulletin encourages investors to consider the issuer's estimated value of a structured note, and whether it is relevant to one's investment decision.

"Bail-inable" Structured Notes

Given the effectiveness of the Bank Recovery and Resolution Directive (BRRD) for EU member states, many issuers of structured products have now added the requisite disclosures to their offering materials and program documents.

As a reminder, the BRRD addresses the resolution of a failed bank and attempts to do so through an orderly process designed to, among other things, avoid disruption to the financial system as a whole, minimize contagion risk, protect depositors and avoid a taxpayer injection of support. In order to advance these objectives, the BRRD equips regulators with a number of prudential and supervisory tools. If a resolution authority has determined that an institution is failing or likely to fail, then the resolution authority may use its "bail-in" authority and impose losses on losses on liabilities owed by a financial institution (other than specified excluded liabilities) where such liabilities would not, by their terms, be required to absorb such losses. For example, a debt security can be converted into common equity.

In order to comply with the resolution regime, issuers subject to these requirements have: added prominent disclosures in their offering materials regarding the possibility of bail-in, and holders must agree to be bound by the terms of a bail-in.

The "bail-in" tool is different from and should not be confused with the requirement for certain systemically important institutions to maintain minimum levels of total loss absorbing capital, or TLAC. As discussed in our last issue of this newsletter, TLAC is intended to provide "buffer" capital for an institution such that it can withstand stress scenarios and avoid failure and resolution.

Northern Bound: Canadian Regulators Adopt Certain U.S. Regulatory Principles

In January 2015, the Staff of the Canadian Securities Administrators (the "CSAs")[8] issued notice 44-305, "Structured Notes Distributed Under the Shelf Prospectus System." The notice sets forth the CSA's views relating to a number of key issues arising in connection with structured notes under the Canadian shelf prospectus system.[9]

In general, the notice provides guidance for public offerings into Canada as to:

- disclosure issues in offering documents;
- post-issuance disclosure considerations to investors; and

[8] The CSA is an umbrella organization of Canada's provincial and territorial securities regulators, which aims to improve, coordinate and harmonize regulation of the Canadian capital markets.

[9] A copy of the guidance may be found on the websites of several of the Canadian provincial securities regulators, including the following link: http://www.osc.gov.on.ca/documents/en/Securities-Category4/csa_20150122_44-305_structured-notes.pdf. The notice updates the CSA's prior guidance set forth in CSA Staff Notice 44-304 – Linked Notes Distributed Under Shelf Prospectus System (SN 44-304), which in turn may be found at: https://www.osc.gov.on.ca/documents/en/Securities-Category4/csa_20070720_44-304_linked-notes.pdf

- the CSA's filing process to "pre-clear" the offering documents for new structures.

In this article, we address a number of ways in which the CSA guidance compares to recent guidance from U.S. regulators.[10]

Fees, Pricing and Estimated Value

Disclosures. Taking a page from recent U.S. regulatory developments, the notice states that structured note issuers should "ensure that their disclosure provides sufficient transparency regarding fees including any financial benefits the issuer may embed into the structuring and pricing of the notes. The disclosure should enable an investor to readily assess the costs of investing in the note and the potential financial benefit the issuer and dealer will receive from the sale of the note. The disclosure required will vary depending upon the fee structure and whether the issuer has embedded a profit component into the offering price of the note."

Accordingly, in addition to disclosing all of the relevant fees received by structured note issuers and underwriters, the CSA will request issuers to add the following disclosures:

- cover page disclosure of the issuer's estimate of the note's fair value based on its valuation of the economic components that could be combined to provide the same exposure as the structured note;[11]
- a brief explanation that the fair value of the note is based on the issuer's estimate of the value of the note's economic components and a brief description of what those components are;
- an explanation regarding why the issuer's estimate of the note's fair value may be different from the offering price, including whether the offering price includes an estimated profit for the issuer, and what fees, costs or other amounts that the issuer adds to its estimate of the note's fair value; and
- an explanation that the issuer's estimate of the note's fair value may differ from the price at which an investor can sell the note in the secondary market, and why.

In addition to the cover page disclosure, the CSA recommends that the disclosures of these matters be addressed in a separately captioned section of the offering document, and in the "risk factors" section.

The CSA staff noted that it may request issuers to provide, confidentially, a description of the valuation models and assumptions used to estimate the fair value of a particular note.

Policies and Procedures. In addition to the above disclosure documents, the CSA will generally ask issuers to include a statement in their disclosure documents to the effect that they have adopted written policies and procedures for determining the fair value of the note, which include:

- the methodologies used for valuing each type of component embedded in the note;
- the methods by which the issuer will review and test valuations to assess the quality of the prices obtained, as well as the general functioning of the valuation process; and
- conflicts of interest.

Pre-Inception Performance Data ("Backtesting")

The notice indicates that it has reviewed disclosure documents, for quantitative models in particular, that sought to include hypothetical or back-tested performance data regarding how the model or strategy would have performed had it been in existence prior to the date of actual inception. The CSAs are concerned that the disclosure of this type of information in

[10] The notice also addresses a variety of additional disclosure issues, many of which are reflected in U.S. disclosure documents as well, including suitability disclosures, descriptions of linked assets, and hypothetical examples.
[11] Similar to the SEC, this approach appears to treat the valuation of a structured note as the sum of its components – (a) "bond value" and (b) "derivative value."

the prospectus supplement has the potential to be "overly promotional and misleading." As a result, the CSAs have requested its removal from offering documents.

This approach reflects FINRA's guidance as to advertising materials provided to retail investors, but is more restrictive than the SEC's disclosure regime for prospectuses. We discuss these differences in our article in our December 1, 2014 issue of this publication, which may be found at the following link: http://www.mofo.com/~/media/Files/Newsletter/2014/12/141201StructuredThoughts.pdf (page 2).

Impermissible Disclaimers

Similar to the SEC's 2012 "Sweep Letter" (comment 11),[12] the CSA indicated that issuers should not include disclaimers for liability as to third party information, such as index descriptions. The CSAs believe that such disclaimers and cautionary language do not reflect the Canadian securities law liability scheme. However, as in the U.S., the CSA permits issuers to identify information as third party information, and to state that the issuer has not verified the accuracy or completeness of such information.

Continuing Review

The notice indicates that the CSA staff will continue to review structured notes filed for pre-clearance and to monitor the development of the market. The CSA will consider what gaps may exist under its regulatory approach, and whether additional regulatory requirements may become necessary.

Toronto Stock Exchange Proposes New Listing Requirements for Structured Products

In January 2015, the Toronto Stock Exchange (the "TSX") released proposed amendments to its rules setting forth a set of listing rules for a variety of products, including structured products and closed end funds.[13]

In issuing the proposal, the TSX noted that, at present, none of the leading Canadian banks that issue these products list them on an exchange. The TSX also determined that there are currently only three providers of listed structured products in Canada, with only six products listed on the TSX or on other Canadian exchanges. As a result, the TSX believes there may be benefits to public listings for this product class, and proposing a single set of listing rules.

Among other things, the TSX is proposing a capitalization requirement of CAD$1 million for structured product listings.

A Look to the U.S. Exchanges

In creating the proposed rules, the TSX reviewed the listing rules and practices on a number of international securities exchanges. The TSX noted that the products listed on Nasdaq and the NYSE are the most comparable to the products listed on the TSX.

What Is a Structured Product?

For purposes of the proposed rules, the term "structured product" means securities generally issued by a "Financial Institution" (or similar entity) under a base shelf prospectus and pricing supplement where an investor's return is contingent on, or highly sensitive to, changes in the value of underlying assets, indices, interest rates or cash flows. Structured products include securities such as non-convertible notes, principal or capital protected notes, index or equity linked notes, tracker certificates and barrier certificates. The TSX, in its discretion, may determine if a particular issuance of securities will be considered a structured product.

[12] The letter is available at the SEC website at the following link: http://www.sec.gov/divisions/corpfin/guidance/structurednote0412.htm
[13] The proposed rules, including useful summary tables, may be found on the TSX's website at the following link: http://tmx.complinet.com/en/display/display.html?rbid=2072&element_id=889

Comment Period

The TSX is publishing the proposed rules for a 60-day comment period, which expires on March 16, 2015.

Seminar: A Conflicts-Based Approach to SEC and FINRA Priorities

Join Morrison & Foerster on Tuesday, March 31, 2015, for a complimentary CLE session titled "A Conflicts-Based Approach to SEC and FINRA Priorities." This event will be held at Morrison & Foerster's New York offices. Led by former members of FINRA Enforcement—MoFo Partner Daniel Nathan and Assistant General Counsel at JPMorgan Chase, Julie Glynn—will look at FINRA's focus on its examinations and investigations through the lens of broker-dealers' efforts to address the conflicts inherent in their business. This session will provide suggestions about how firms can identify and address these conflicts in a way that will make regulators comfortable and lower the anxiety level around FINRA examinations.

For more information about this event, or to register, click here.

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For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/Thinkingcapmkts.

Morrison & Foerster has been named Structured Products Firm of the Year, Americas, 2014 by *Structured Products* magazine for the sixth time in the last nine 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, and 2014 by *Structured Retail Products.com*.

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

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

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