
Legal Updates & News

Legal Updates

Short-Term Pain, Long-Term Gain

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Structured products, once the domain of institutional investors, have entered the radar of the retail investment community. This has caused excitement and concern in equal measure. The explosion in the number of high-net-worth (HNW) individuals, combined with increasingly sophisticated tastes among retail investors, has created a demand for more tailored and complex investment opportunities. Recently, though, the liquidity crisis forced questions about the ability of retail to understand the potential risks of investing in these vehicles. For a while it seems that structured products, as well as their point of origination and distribution, will come in for closer scrutiny. Rather than being a bad omen, this process may actually complement existing initiatives to bring clarity to an opaque market. It may ultimately ensure the market's long-term growth.

While structured products for the retail market may only now be creating waves in the broader business community, it is by no means a new initiative. Financial institutions in the US and Europe spotted the potential in European retail markets and leapt into action some time ago. There are several jurisdictions where local regulation caters to these products. Germany, the Netherlands and Switzerland all have reasonably mature markets for retail-structured products. In addition, the growth in HNW individuals in areas such as Russia and other emerging markets provides interesting potential. The UK market in retail-structured products has historically been small. Nevertheless, it is growing in both size and significance. London is rapidly establishing itself as the centre of global innovation.

A liquidity crisis is one of the toughest tests that a product can face. Some commentators have queried the degree to which a prolonged lack of liquidity in the market can affect certain products. Others have highlighted the lack of investor understanding about the assets or types of assets that underlie their investments, and the degree of their exposure to certain geographical or industry sectors. The matter raises an important question: is it the responsibility of the originator or the distributor to ensure that the retail market is sold a product which it understands and which matches its appetite for risk? There is no simple answer. For a start, the method of distributing retail-structured products can vary a lot by geography. In the US for example, investment banks or their affiliates often deal directly with end investors. In Europe, it is more common to distribute structured products through intermediaries. This reflects the diverse nature of the European markets and the difficulty of maintaining effective internal distribution channels in multiple jurisdictions.

Balancing Responsibilities

Whoever the distributor, it is clearly in the interests of all parties that the end investor is sold a product which is appropriate for their circumstances and risk appetite. When the distribution of retail products is made through a chain of intermediaries, the situation becomes more complex. Then it is essential that all the parties involved in the distribution chain understand the product. They must understand its purpose as well as their respective responsibilities.

A breakdown of understanding between the relevant participants can damage a bank's most

precious commodity – its reputation. It is imperative that the product provider considers early the nature of the relationship between itself and the distributor, as well as the sub-distributors and investors. This is particularly important when distribution is to be made within a number of jurisdictions. The provider should be aware of the capacity of each party to understand. It should also evaluate the product.

The product provider and its legal advisers should ensure that they identify and comply with the relevant rules and regulations in each jurisdiction. In particular, they must ensure that documentation prepared in connection with the sale, distribution, and any listing of the product, adequately describes the product and its associated risks. This might sound like a statement of the obvious. But structured products are inherently complex. Typically, they combine traditional debt instruments such as bonds and loans, with derivatives. In addition, they will often be structured through special purpose entities including partnerships or funds.

The investments will also often reflect the risk appetite of different categories of investors. Different layers in the structure often hold underlying assets that may be located in various jurisdictions. Cash flows within the structure and amounts payable to investors are often based on complex algorithms. It can be a challenge to identify all relevant commercial and legal issues and to describe the product, as well as the material risks, in a way that retail investors with different levels of knowledge can understand. The product provider should decide whether its product is suitable for retail investors as a group. The distributor should be aware of the particular risk profile and requirements of the end investor.

Somewhat frustratingly, the answer to the question of where the responsibility should lie for communicating material information is, with both groups. The product provider is responsible for preparing and disclosing information that will help distributors and retail investors to understand the product. The product developers and distributors must discuss the particular investor's risk appetite and whether the product meets those requirements. The party that has direct contact with the end investor, whether that is the distributor or sub-distributor, should know most about the investor's circumstances. It is they who have the responsibility of physically explaining the product to the end investor.

Inevitably, relationships in a retail distribution chain do not always fall neatly into categories. The boundaries of respective responsibility are often blurred. Adequate communication between product providers and distributors is essential to ensure that all parties agree on the division of responsibilities regarding their legal and regulatory obligations. The issue of the relationship between the product provider and distributor, and the question whether investors are provided with sufficient information to understand the products they are purchasing, is of crucial importance to regulators.

When products are distributed primarily within the EU and EEA, the EU's Financial Services Action Plan (FSAP) has helped to make the regulatory landscape more uniform. The creation of a single market in financial services is a core aim of the FSAP. It has issued a range of directives and regulations that have helped to create a more level playing field in Europe; they include the Prospectus Directive, the Transparency Obligations Directive, the Market Abuse Directive and the Market in Financial Instruments Directive (Mifid). There remains scope for individual regulators to interpret provisions in different ways, or to impose additional rules and regulations.

Treating Customers Fairly

In the UK, the Financial Services Authority (FSA) has increasingly adopted a principled approach to regulation. It has not set out detailed rules relating to the sale and distribution of retail structured products. Under its Treating Customers Fairly initiative, the FSA published a policy statement in July 2007 that updated a discussion paper that it had published in September 2006. This set out guidance on the respective regulatory responsibilities of providers and distributors of financial services. The paper is relevant to retail-structured products, but it is also generally applicable to all retail products. Within its overview section, the policy statement says that, in line with the FSA's principles-based approach, the guidance does not provide detailed rules. It has instead set out high-level responsibilities. It leaves it to the firms to decide how best to fulfil them.

The guidance notes in the FSA Policy Statement divide responsibilities strictly between product providers and distributors. The FSA states that firms cannot delegate their regulatory responsibilities. It acknowledges that there may be cases where it is appropriate for them to apportion responsibility between themselves; one example is when the product provider and

distributor are both involved in the design of an investment. Whether such apportionment is appropriate will depend on the particular circumstances of each case.

The guidance identifies responsibilities of the product provider and distributor that cover the product's life-cycle. The role of the product provider is to identify the target investor market for which the product is likely to be most suitable. They should stress-test the product in a variety of market environments and put in place adequate risk-control arrangements. The product provider should also consider whether the information that they give to distributors is sufficient, appropriate and comprehensible and whether it will enable the distributors to provide suitable advice (if relevant) to the end investor. If they are providing information to customers, they should assess the likely levels of financial capability within that market. They must take into account the information that the customer needs to understand the product and the risks associated with it. When selecting distribution channels, the product provider should determine whether the nature of the product is such that the end investor should seek advice. The product provider must also check to see whether what occurs in practice corresponds to (or deviates from) what was originally planned for the distribution of the product. If it is appropriate, they should cease to use a particular distribution channel. After the sale, the provider should periodically review products whose performance may vary materially to check whether they are continuing to meet the needs of its target audience. If they are not, the provider must communicate with the distributor or the end investor, and consider what additional action needs to be undertaken.

The distributor must put in place systems and controls to manage the risks that financial promotions pose. They must act with due skill, care and diligence in passing on promotional materials. If they are providing information to a customer, they should consider whether they sufficiently understand the information they are to provide. If they do not, they should not distribute the product. Rather, they should ask the provider to supply the information or training that is necessary to enable them to achieve the necessary level of understanding. When they are advising on the selection of the product provider, the distributor must consider the nature of the products or services that the provider is offering. They should think about how these fit the customer's needs and risk appetite. They should also consider what impact the selection of a given provider could have on the customer, in terms of charges or financial strength. In relation to post-sale responsibility, the distributor should comply with all contractual obligations to the investor. They should ensure that they comply with any implied or express representations.

The Netherland Findings

The FSA is not a lone voice in its concern about the respective responsibilities of provider and distributor. The Netherlands regulator, Autoriteit Financiële Markten (AFM), has also published an exploratory analysis on structured products. The paper contained a summary of the nature of the market in the Netherlands. It considered whether investors are capable of understanding the way in which structured products work. Independent research conducted on behalf of AFM showed this to be a valid worry. Potential investors with a range of (and sometimes no) experience of investing in structured products were asked whether they understood how particular structured products worked. The findings showed that a large proportion of respondents failed to understand critical elements. Blind spots included redemption mechanics and the implications of an early redemption of the sample product. In particular, the AFM found that much of the information provided to investors (including that contained in prospectuses) was inadequate to help them make an informed investment decision.

While the AFM paper contains few concrete recommendations, it restates recommendations issued by the Netherlands Bankers Association (NVB) in February 2007. These concern the information that other prospectuses or materials relating to structured products should provide. The AFM has indicated that it will provide a further public information folder to assist investors in the process of purchasing structured products in due course.

In a parallel initiative to the FSA's paper, five leading trade associations issued a draft set of non-binding principles relating to retail-structured products. The group comprised the European Securitisation Forum (ESF), the International Capital Market Association (ICMA), the International Swaps and Derivatives Association (Isda), the London Investment Bankers Association (Liba) and the Securities Industry and Financial Markets Association (Sifma). These retail-structured products (RSP) principles were drafted with no particular jurisdiction in mind. They focus primarily on managing the relationship between providers and distributors. Crucially, the principles emphasise the common interest that providers and distributors share in satisfying their customers' legitimate expectations for the investment's performance.

The sponsoring associations believe that market participants should be free to arrange their relationship and relative responsibilities on a case-by-case basis. The principles are intended to be broad enough to provide a reference framework for retail-structured products markets globally. In summary, these principles include the following recommendations. Product providers should establish formal internal approval processes for retail-structured products which address both product structuring and distribution issues. When the investor is the client of the distributor, the product's suitability is exclusively an issue for the distributor. Distributors must understand the products they distribute. When they give term-sheets or other marketing materials to their clients, the distributor must take responsibility for their accuracy and completeness. They must also be satisfied with their compliance with local laws and regulation, even if they incorporate material provided by the product provider. Product providers should ensure that their materials are accurate, fair, balanced and clear. They must present the material in a way that is consistent with their obligations to the distributor. If the provider assists the distributor by providing information, this information should be clear and of the kind which the distributor has requested in preparing their own product description. When they begin dealing with a distributor, product providers should consider whether the distributor is appropriate for placing the product. If the provider thinks it is necessary, practical and appropriate to do so, they should conduct a due diligence process. Distributors should evaluate product-provider counterparties and conduct a similar process. Product providers and distributors should agree on and record their respective roles and responsibilities towards investors.

The wide range of structured products and the divergence of legal and regulatory requirements in different jurisdictions mean that these principles are extremely general. Critics have said that the guidance is too broad to be of any practical value. Nevertheless, market participants will show considerable maturity if they can demonstrate their ability to self-regulate by adhering to these principles. For the market to truly develop and learn from the lessons of previous months, a mature dialogue between participants and regulators must take place. Industry practitioners should share best-practice standards with trade associations and regulators to facilitate debate. Such discussions would develop useful principles that all sectors can adhere to without the burden of unnecessary regulations.

In its July policy statement, the FSA welcomed initiatives by trade associations to provide guidance in relation to particular products. They view it as complementary to their own work. But the FSA thinks that industry action on its own is insufficient; at least at a high level, a degree of regulatory guidance is necessary.

These initiatives were favourably received, but none of them could reduce the impact of the volatility in the credit markets. This has made it more difficult to sell structured products. The US sub-prime fallout has affected demand for asset-backed securities and CDOs. This in turn has tainted the broader securitisation and structured-products market. But the market will adapt. For example, the trend for retail investors to require less in the way of capital protection for their investments may well be reversed. In addition, products linked to residential mortgages, particularly the sub-prime market, are unlikely to see significant issuances in the near future. In general, there does not seem to be any particular reason why credit-linked, equity-linked and other products should not continue to be in demand.

Recent events have certainly shaken the retail-structured products market. But the risk to its medium- to long-term potential is not severe. The market is moving in the right direction, by establishing where the responsibilities lie in selling structured products to retail investors. Although the recent publications by the FSA, the AFM and the trade associations cover slightly different ground, they share a consistency that benefits the market.

Speculation that some investors have been unduly influenced by the credit rating given to a particular product, rather than the strength of the underlying assets, has provided a valuable lesson for the end investor. This means that the role of the rating agencies and their criteria are likely to come under scrutiny in coming months. More importantly though, investors are aware of the need to focus on the nature and the underlying risks of the product they are acquiring, as well as the importance of taking the appropriate advice. In the future, all parties – regulators, trade bodies, advisers, issuers, distributors and even the end investors themselves – need to work together to ensure that retail investors fully understand the detail of structured products, as well as their risks. A healthy distribution system for structured products cannot protect investors against all risks. Yet the market should ensure that investors are able to enter into the investment with their eyes wide open regarding the product's potential dangers and rewards. Now that the market is united in achieving this goal, retail investors may be able to fully participate in a dynamic and growing market.

