

STRUCTURED THOUGHTS

NEWS FOR THE FINANCIAL SERVICES COMMUNITY

IN THIS ISSUE

FINRA EXAMINATION FINDINGS
AND STRUCTURED PRODUCT
SALES

PAGE 1

PRIIPS – ESAS’ LETTER TO THE
EUROPEAN COMMISSION
REGARDING GUIDANCE ON KEY
INFORMATION DOCUMENTS ON
INVESTMENT FUNDS

PAGE 3



FINRA EXAMINATION FINDINGS AND STRUCTURED PRODUCT SALES

On December 7, 2018, [FINRA released its report](#) describing its examination findings. A number of FINRA’s findings in the report directly relate to the structured products industry and should be carefully considered by both manufacturers and distributors of these products. The report repeats some of the concerns raised in FINRA’s related report in 2017, indicating that not all market participants have successfully embraced FINRA’s guidance.

SUITABILITY

Product suitability, and broker-dealer compliance, with FINRA Rule 2111 remains a concern. The report notes:

“FINRA observed situations where registered representatives did not adequately consider the customer’s financial situation and needs, investment experience, risk tolerance, time horizon, investment objectives, liquidity needs and other investment profile factors when making recommendations; in others, they failed to take into account the cumulative fees, sales charges or commissions. In some cases, unsuitable recommendations involved complex products (such as leveraged and inverse exchange-traded products (ETPs), including exchange-traded funds (ETFs) and notes (ETNs)). In other cases, they involved overconcentration in illiquid securities, variable annuities,

switches between share classes, and sophisticated or risky investment strategies. FINRA also remains concerned about recommendations of unsuitable mutual fund share classes and Unit Investment Trusts (UITs), as discussed in the 2017 Report on Examination Findings. Inadequate product due diligence across product classes, including failure to understand the specific features and terms of products recommended to customers, was a common contributor to the challenges FINRA observed.”

In order to help prevent these situations from occurring, FINRA indicated some firms that maintained sound supervisory practices for suitability generally identified risks, developed policies, and implemented controls tailored to the specific features of the products they offered and their customer base. These controls included, for example:

- restricting or prohibiting recommendations of products for certain investors;
- establishing systems-based controls (“hard blocks”) for recommendations of certain products to retail investors, in order to ensure that registered representatives adhered to those restrictions or prohibitions;
- requiring registered representatives, including principals with supervisory responsibilities, to receive training on specific complex products before recommending them.

According to the report, FINRA also identified a number of concerns about over-concentration in connection with structured product sales. For example some broker-dealers maintained customer accounts that were concentrated in complex structured notes or sector-specific investments, which were unsuitable for customers and resulted in significant customer losses. Some registered representatives recommended structured notes or sector-specific investment strategies to customers who may not have had sufficient sophistication to understand their features and without considering the customer’s individual financial situation and needs, investment experience, risk tolerance, time horizon, investment objectives, liquidity needs, and other investment profile factors. Some recommendations involved illiquid securities with limited price transparency, which made it difficult for investors to know the true value of their investment and led them to believe that their investments would not fluctuate in value. In some instances, firms did not have procedures or systems reasonably designed to identify and supervise the concentration of these products in customer accounts.

FINDINGS FROM FINRA’S 2018 SWEEP RELATING TO VOLATILITY-BASED PRODUCTS

In our [April 2018 edition of this publication](#), we discussed FINRA’s sweep relating to volatility-linked products. The sweep arose from trading activity in February 2018, when significant increases in the VIX Index resulted in substantial losses to investors who held products that were inversely linked to the index. The new FINRA report discusses its findings from the sweep.

FINRA reports that many of examined firms had comprehensive written supervisory procedures and controls regarding these products. Several firms prohibited or restricted representatives’ recommendations to retail clients for either all or some volatility-linked products, such as inverse or leveraged exchange traded products or other products. Controls and practices to enforce these restrictions included:

- system-based controls;
- stringent net worth conditions or other pre-qualification criteria;
- requiring signed risk acknowledgement forms;
- completing written certifications attesting to customers’ product knowledge; and
- providing specialized training as to these products.

However, the report urges distributors of these products (and other complex products) to focus on the following issues, as follows:

“Unsuitable Recommendations – Despite prospectuses and other materials that included risk disclosures, including explicit warnings about sales to retail customers, some firms nevertheless marketed volatility linked products to retail customers who did not understand those products’ unique risks and made recommendations that were inconsistent with the investors’ investment profile, including risk tolerance and investment time horizon (e.g., in many of those instances, customers held the securities far longer than the holding periods—frequently one trading day—recommended in the prospectus).

Inadequate Due Diligence – In some cases, firms’ due diligence did not address volatility-linked products’ unique characteristics and risks, such as the potentially magnified impact volatility in the VIX index and VIX futures, as well as operational features of the volatility-linked products themselves, which could affect the products’ performance. As a result, some firms were not aware—either through their own testing and analysis or through reliance on a third party—that

volatility-linked products, in particular those offering short-volatility exposure, could be susceptible to steep losses in value within a very short timeframe, even while equity markets experienced relatively moderate declines.

Insufficient Systems and Controls – Some firms did not address the risks of offering complex leveraged, inverse and volatile products, including volatility-linked products, to retail customers. Other firms identified these risks, but lacked the operational capacity to enforce the limited conditions under which they permitted the sale of such products to retail investors. Further, some firms’ controls for volatility linked products did not comply with the firms’ own WSP restrictions for such products. Other firms did not recognize when a new product on their platform was a volatility-linked product and, as a consequence, did not implement appropriate controls.”

OUR TAKE

FINRA’s examination report can be viewed as a call for broker-dealers to review their sales and training procedures to understand whether they are in compliance with FINRA’s rules and guidance. In addition, in connection with their ongoing “know your distributor” procedures, product manufacturers and distributors will want to probe whether their sub-distributors are aware of the challenges that must be addressed in selling complex products, and whether they are taking appropriate steps to address them.

PRIIPS – ESAS’ LETTER TO THE EUROPEAN COMMISSION REGARDING GUIDANCE ON KEY INFORMATION DOCUMENTS ON INVESTMENT FUNDS

As we reported in *Volume 9, Issue 5 of Structured Thoughts*, the UK’s Financial Conduct Authority issued a Call for Input in relation to the packaged retail and insurance-based investment products (PRIIPs) regulation and the production of a standardized key information document (KID) required thereunder, which Call for Input closed in September 2018. Following on from that, the three European Supervisory Authorities (ESAs), the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European

Securities and Markets Authority, published a letter sent from them to the European Commission dated October 1, 2018 in relation to KIDs for investment funds.

BACKGROUND

Under the PRIIPs regulation, investments in retail-focused investment funds, known in Europe as “UCITS” funds, are exempt from the PRIIPs regulation until December 31, 2019. As such, UCITS management companies, and persons advising on, or selling, units of UCITS funds are exempt from producing and providing a KID to retail investors until such date. The main reason for the delay in application of the PRIIPs regulation to UCITS funds is the fact that persons selling units in UCITS funds have, for many years, been required to provide investors with a similar standardized, short form disclosure document called a key investor information disclosure document or “KIID”, and therefore it is necessary to consider carefully the best way in which the PRIIPs regime could be extended to UCITS funds.

As a separate matter, the PRIIPs regulation itself is scheduled to be reviewed by December 31, 2018. However, this review expressly includes the consideration of whether the current transitional arrangements for UCITS funds should be prolonged, or whether the current provisions in the UCITS Directive in relation to KIIDs might be replaced by, or considered equivalent to, the requirement for the KID under the PRIIPs regulation.

By a letter dated July 6, 2018, the European Commission sent to the ESAs a request to develop guidance on the production and distribution of KIDs on investment funds as from January 1, 2020, and the Commission further clarified that request in a letter dated August 10, 2018.

LETTER

In the ESAs’ letter of October 1, they stated that they were of the view that an approach whereby retail investors in UCITS funds will receive both a KID under the PRIIPs regulation and a KIID under the UCITS legislation as from January 1, 2020 is not satisfactory and risks undermining the aims of the PRIIPs regulation.

This is because, unless the information provided on a product within the scope of the PRIIPs regulation is short and concise, there is a risk that retail investors will not use it. The ESAs are of the view that these overlapping disclosure documents could in fact deter retail investors from using them, rather than facilitating their informed decision making.

They also expressed doubt that the information required for the KIID could be effectively articulated together with the information required for the KID, since the technical differences in the methodologies underlying the presentation of risks,

performance and costs in the two documents could mean that the documents will not provide consistent information to the investor. Furthermore they were doubtful that any guidance by the ESAs could allow retail investors to appreciate the differences in this information. By way of example, they highlighted that the summary risk indicator for KIDs and the synthetic risk/reward indicator for KIIDs under UCITs would result in different risk indicators for a material number of PRIIPs products.

NEXT STEPS

Therefore, the ESAs are of the view that other solutions are needed to avoid a situation of duplicate information requirements as from January 1, 2020, and these other solutions may include legislative changes.

They also believe that a targeted review of the PRIIPs delegated regulation on KIDs is appropriate to address issues that have arisen from the practical application of this delegated regulation.

As such, the ESAs propose to launch a public consultation in the fourth quarter of 2018, in order to collect feedback on the most high priority issues and they aim to submit proposed amendments to the European Commission in the first quarter of 2019. In particular, the ESAs expect to examine issues related to performance scenarios and whether the performance scenarios are providing reasonable expectations for investors as to possible future returns. They also will consider whether other targeted amendments are needed to address issues that have been highlighted in questions and answers published by the ESAs to date.

CONTACTS

Lloyd S. Harmetz
New York
(212) 468-8061

Jeremy C. Jennings-Mares
London
44 (20) 79204072

We are Morrison & Foerster — a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, and technology and life sciences companies. *The Financial Times* has named the firm to its lists of most innovative law firms in Northern America and Asia every year that it has published its Innovative Lawyers Reports in those regions. In the past few years, *Chambers USA* has honored MoFo's Privacy and Data Security, Bankruptcy, and IP teams with Firm of the Year awards, the Corporate/M&A team with a client service award, and the firm as a whole as Global USA Firm of the Year. Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. The firm also has a long history of commitment to the community through providing pro bono legal services, including litigating for civil rights and civil liberties, improving public education for poor children, advocating for veterans, promoting international human rights, winning asylum for the persecuted, and safeguarding the environment.