Legal & Regulatory Developments in Structured Retail Products

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EFMLG-FMLC-FMLG Trilateral

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Agenda

- Options for Retail Structuring
- International Focus on Structured Products
- Relevant EU Issues
- FSA Initiatives
- Recent Cases
- Themes for the Future
Issues in UK Retail Structuring

- Securities Regulation
- Conduct of Business Regulation
- Consumer Protection Law
Scope of Securities Regulation

- Retail Bonds & Warrants
- Listed Wholesale Bonds & Warrants
- Highly Structured Notes
- Closed Ended Investment Companies
Conduct of Business Regulation of Securities Offerings in the UK

- Effective ban on direct offers of derivatives

- Derivatives may only be the subject of an advised sale, or bought on a discretionary basis, where a full suitability fact-find has been done on the client

- Derivatives includes most structured bonds, warrants and notes but not shares in closed-ended investment companies
Avoidance of Securities Regulation – UCITS Regulated Funds as Repackaging Vehicles

- Public offerings of open-ended fund units fall outside securities regulation and bars on derivative distribution

- S.238 FSMA prohibits the public offering of unregulated fund units in the UK

- Public offering of UCITS must be done using a prospectus in the form required by the FSA CIS Sourcebook

- Liability for UCITS prospectus
  - Strict liability subject to due diligence
  - Directly actionable only by private person
Retail Repackaging – Other Products

- Structured Deposits
- Life Policies
- Retail OTC Derivatives
International Focus on Retail Distribution of Structured Products

- CRMPG II
  - Identifies sales of complex products to retail investors as an issue of “heightened reputational risk”
  - Recommends “know your distributor” procedures

- NASD Guidance
  - Product disclosure and fair advertising
  - Suitability
  - Risk control systems
  - Training
EU Issues

- **Prospectus Directive**
  - Requires consolidation of the distribution chain for public securities into a single “offer”

- **Markets in Financial Instruments Directive**
  - Draft conduct of business rules
    - Art 10(1)(c) – a distributor who has done suitability on a client may not recommend to that client a product which he does not believe that the client understands
    - Art 11 - a distributor may not provide an execution-only service in a complex product (including any derivative)
    - Art 19(3) – all clients must be provided with information as to financial products, including appropriate risk warnings, in a form comprehensible to them
FSA Treating Customers Fairly (TCF) Initiative

- Expansion of Principle 6
  “A firm must pay due regard to the interests of its customers and treat them fairly”

- TCF addresses the whole sales cycle, from structuring to complaints handling

- Applies the same test to steps which take place between institutions as to those which take place within them

- Is being implemented this year through ARROW review
Obligations of Product Structurers and Designers under TCF

- Product provider must consider
  - How the product would perform in different market scenarios – stress-testing
  - Which target groups of customers is the product suitable for – and which not
  - How can the products features and risks be made comprehensible to customers
  - Will the product material enable intermediaries to understand and explain it
  - Whether there is a requirement for infrastructure (valuation, reporting, complaint handling) after sale
FSA Identified Problem Areas

- Handover between technical and sales people
- Provision of information to distributors
- Relying “excessively” on distributors having specialist knowledge
- Inadequate training of service staff to handle queries from distributors after product launch
- Inadequate post-sale systems and complaints handling
Recent UK Litigation

- Seymour v Ockwell
  - Liability of a product provider for activities of intermediary

- Peekay v ANZ
  - Liability of a distributor for inaccurate marketing
Common Elements of Regulators’ Concerns

- Accurate information about the product
  - Information provided to sales staff
  - Control and training of sales staff
- Adequate, balanced risk disclosure
- Class based suitability analysis
- Risk assessment and control systems by appropriately senior management
- Liability for activities of third parties
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