Morrison & Foerster's Anna Pinedo and the Structured Products Association's Keith Styrcula discuss the introduction and advent of structured products in the US, in particular the role of regulators in the crucial period following the 2008 market break and, with more growth expected, how the US market has much to look forward to

When and why did structured products take off in the US?

Keith Styrcula: About seven or eight years ago, Barclays Capital and Deutsche Bank came out with exchange-traded notes (ETNs), which were basically structured notes that were 'delta one' indices. Accordingly, if you put a dollar into the note, you'd get a dollar of exposure to the index.

Now there are more than 200 ETNs, and this has led financial advisers to take a look at index-linked notes as a cost-efficient, tax-efficient way of investing in indices. I think that's the lodestone of how structured products began to take off in the US.

In an environment where the Federal Reserve is keeping the interest rates close to zero on Treasuries, it's been very difficult for US investors to find investment opportunities where they can get a suitable return for long-term goals such as retirement and college education.

Structured notes provide that income opportunity through range accrual notes, step-up callables and steepeners. These instruments are a bit more sophisticated than the average fixed-income note, but they combine hybrid features to provide the type of yields that investors need to achieve their target objectives.

How will implemented regulation affecting structured products change product creation and distribution?

Anna Pinedo: After the financial crisis, at least in the US, we've seen a variety of new developments and heightened regulatory interest relating to structured products. For example, the US Securities and Exchange Commission (SEC) has required that issuers of retail or registered structured products include additional disclosure recording estimated initial value, conflicts of interest, and other items that the SEC believes would provide additional information for retail investors.

The SEC and the Financial Industry Regulatory Authority (Finra) have also cautioned against products that may be viewed as overly complex for retail investors, so I think that the dynamic has caused issuers and distributors of structured products to focus on simpler products that can be issued on a more regular or routine basis.

Keith Styrcula: Since the 2008 market break, there's no question that the regulators, particularly the SEC and Finra, as well as the state regulators, have come in and shown an increased interest in overseeing the sales and marketing practices of structured investments. We've seen this phenomenon significantly impact the way firms conduct business. However, because the Structured Products Association (SPA), Morrison & Foerster and many of the issuing firms have worked hand in glove to give transparency to the regulators, they have come away with a sense that we, as an industry, are looking out for investors' best interests, particularly in terms of providing the types of investments that enhance yield and achieve specific goals for individual investors.


Anna Pinedo (left), Partner, Morrison & Foerster
Keith Styrcula (right), Chairman, Structured Products Association

We take considerable pride in our industry by creating instruments that perform for investors in a way that many plain vanilla instruments cannot. Particular principal-protected notes and buffered notes can dial out some or all of the downside risk of an investment [while providing] upside on a particular index.

Complex products – for example, basket products – got bad press in the crisis; was that entirely fair?

Anna Pinedo: After the financial crisis, there was an almost instinctive reaction on the part of regulators, as well as the general press, and they viewed complex products with a very broad brush.

That was largely unwarranted, in that a more in-depth look at products that have been termed 'complex' reveals that there are lots of different layers and that structured products – which principally are offered in either bond form or as certificates of deposit – generally were not a problem during the financial crisis and offer a fair bit to investors in terms of a safe and generally useful investment alternative.

Keith Styrcula: There's a widely accepted maxim that the structured products industry is a self-correcting one; the more complex a product is in its features and payoff profile, the less likelihood that there will be a successful raise-up. Advisers naturally shun complex investments they themselves don't understand.

What will the future of the structured products market hold?

Anna Pinedo: In the US, we have a lot to look forward to. The structured products market has grown a great deal since its inception and we're seeing that there are more and more new participants entering the structured products market. This includes new issuers of structured products and new broker-dealers that are actively engaged in selling and distributing structured products. We also have an important new channel: investment advisers and family offices that are looking to add structured products as a part of their portfolios for clients.

Given the relatively low penetration level of structured products in the US, there is a lot of growth ahead.

Keith Styrcula: Over the past 10 years, we have seen the overall notional amount of structured investments rising dramatically, often 15 to 20 to 25% increases year after year. This has been the result of investors having a successful experience with the unique attributes of the investment class, by which the notes outperform their benchmarks most of the time. Accordingly, most first-time investors in structured products keep coming back.

Since many investors found that structured notes provided above-market returns, we've been quite successful in competing against cash alternatives. However, at this time, only 15–20% of registered investment advisers introduced structured products into their clients' portfolios; we need to increase that number to about 25–33%, and we can do so in a couple of years with the co-operation of the industry. I believe the industry should come together and have a marketing campaign, an advertising campaign and a public relations campaign to make the case for structured investments as a superior way of indexing or achieving higher yields.

For us to really take notionals to the next level – to be comparable to the volumes of exchange-traded funds and mutual funds – to take market share away, the industry needs to come together with a singular vision. If so, penetration will go from 15–20% of the number of US financial advisers, to above 50%.

What do structurers/distributors have to do to promote structured products?

Anna Pinedo: The most important issue for issuers and distributors promoting structured products is to come up with very clear, plain English, investor-friendly documentation. Documentation that can be used for both marketing and general educational instruction, so that there's a greater level of awareness about structured products, the role that a structured product can play in a diversified portfolio, and how structured products can provide access to underlying reference assets that may not be easily investable for retail investors.

Easy-to-understand disclosure that is very clear, very comprehensive and provides an educational groundwork is crucial.

Keith Styrcula: The phenomenal success of ETNs is highly instructional for the industry. Advisers and investors have rallied around the transparency, simplicity and liquidity of ETNs. At the same time, there remains a general perception that structured notes don't possess such features. And, even when some investments do, we haven't been able to communicate this to the mass-market investing public or most financial advisers.

What we need is more vanilla indexing in the form of delta-one structured notes. Even if such notes are not exchange-traded, this initiative would establish a beachhead for more sophisticated and useful products for investors.

The future of the structured products market in the US may come from a page in the playbook of Europe, where 'certificates' linked to indices are typically delta one – basically, simple, transparent and plain vanilla-type instruments.

If we're able to create a successful delta-one business in the US, whether it's on exchange or off exchange, or both, then I think the door will open more widely to other types of investments, offering investors a little bit of chocolate swirl to their underperforming vanilla investments.

View the full proceedings of the *Structured Products* 10th Anniversary interview with Morrison & Foerster's Anna Pinedo and the Structured Products Association's Keith Styrcula at *www.risk.net/2353278*