

Mohammed Ben Saleem  
Senior Policy Advisor  
International Organisation of Securities Commissions (IOSCO)  
Calle Oquendo 12  
28006 Madrid  
Spain

posdisclosure@iosco.org

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Dear Sir/Madam,

## **Public Comment on Principles on Point of Sale Disclosure**

We welcome IOSCO's invitation to express our views on the Consultation Report on Principles of Point of Sale Disclosure (the "Consultation Report").

### **1. The JAC**

- 1.1 The Joint Associations Committee ("JAC")<sup>1</sup> on Structured Products is grateful for the opportunity to respond to IOSCO's Consultation Report detailing a set of principles to be applicable on a global basis and designed to assist markets and market authorities when considering point of sale ("POS") disclosure requirements (the "IOSCO Principles") in respect of collective investment schemes ("CIS").
- 1.2 The JAC was formed to address the issues which arise out of the retail distribution of structured returns and for most members this issue arises predominantly in the field of retail distribution of structured securities. Many members also distribute structured returns through structured funds and almost all provide structures to insurance companies and other investors which may be repackaged into retail products. The JAC, therefore, does not focus exclusively on one product type. However, it is felt that it is most useful for the JAC to provide information as regards securities. This response, therefore, principally focuses on the issues which arise out of the sale of structured securities to retail investors. Structured securities in this context are primarily in the form of debt securities, certificates and warrants that combine various cash assets and/or derivatives to provide a particular risk/reward profile that allows investors access to broader investment opportunities. The return on structured securities is usually derived from the performance of one or more underlying assets. The JAC has itself produced the July 2007 Provider-Distributor Principles (Annex 1) and the July 2008 Distributor-Investor Principles (Annex 2) (the "JAC Principles") applicable to retail structured products on a global basis.

### **2. Introduction**

- 2.1 The JAC wholly supports the objectives of IOSCO in providing a set of principles to be applicable on a global basis to POS disclosure in respect of CIS. We believe that it is essential for the success of retail financial services worldwide that investors have access to high quality products which meet their investment needs and which are marketed in

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<sup>1</sup> The JAC submission is sponsored by: International Capital Market Association (ICMA) and International Swaps and Derivatives Association (ISDA). Fuller descriptions of the associations appear on page 6 of the submission. In the first instance, any queries may be addressed to rmetcalfe@isda.org

such a way that they can be easily understood and compared. We support the introduction of global principles, since it is appropriate that regulators should maintain high standards of market practice, and the maintenance of such high standards improves consumer confidence. We believe that these objectives should drive the formulation of the IOSCO Principles.

2.2 The primary objectives of the process should, therefore, be:

- (A) to ensure that consumers are provided with sufficient information about financial products to enable them to evaluate those products and to determine what their risk exposure and expectations of investment return should be; and
- (B) to ensure that those selling financial products to consumers should be subject to common regulatory driven standards regardless of the nature of the product sold.

2.3 We do not believe that the current proposals, as formulated, will achieve these objectives and we would urge IOSCO to carry out further work in order to provide further clarity around the roles and responsibilities of different parties within the distribution chain, primarily product providers and distributors, examples of the disclosures required and illustrations of how the IOSCO Principles are intended to operate in practice in order to ensure that:

- (A) regulators do not interpret the IOSCO Principles differently across the EU and the world; and
- (B) any additional costs imposed on market participants are commensurate with the corresponding benefits to investors.

### 3. **Scope of Consultation Report**

3.1 We note that the Consultation Report relates to key information disclosures in respect of CIS but that there is some discussion that further work be undertaken in relation to POS disclosure for products similar to CIS. We strongly suggest that wider consultation is carried out prior to the extension of the IOSCO Principles to other product types in order to obtain participation from stakeholders in all affected products (including structured securities).

3.2 We note that the Consultation Report is applicable largely to sales to "retail" investors but that there is no clear definition of "retail". We believe it would be helpful to formulate a workable definition which would be a directed offering of a product made primarily or exclusively to persons who are (or would be) classified as retail clients for the purposes of, for example, the definition in MIFID in the EU.

3.3 We strongly believe that the proposals apply only to retail investors (and that the IOSCO Principles should not extend to non-retail investors and the wholesale market).

### 4. **Distinction between product types**

4.1 The Consultation Report states that there is a risk that the disclosure regime applicable to CIS, if different from similar products, may put CIS at a competitive disadvantage versus other products which might not be subject to the same requirements. It would be helpful for IOSCO to provide a steer to regulators as to how to harmonise the regimes applicable to different products, in particular, in light of the work in the EU on Packaged Retail Investment Products (PRIIPS) and by the Securities and Futures Commission (SFC) in Hong Kong.

4.2 In particular, the JAC believes that any framework will need to reflect the basic division of CIS and certain products which are akin to CIS into two distinct structural types as follows:

- (A) CIS: CIS are products which entitle their owner to the return on a pool of assets in which his initial contribution has been invested less fees. CIS are variable return investments.
- (B) Contractual packaged retail investment products (PRIPs): Contractual PRIPs are products which entitle their owner to an amount of money calculated by reference to a formula. Contractual PRIPs include deposits, structured bonds, warrants and certificates, annuities and some life insurance policies. Contractual PRIPs are defined return investments.

4.3 We believe that this division will be required to be embedded in any regime, since it drives a number of important distinctions between the regulatory disclosures which are appropriate to the type of product concerned. This will be essential in order to ensure customer understanding of differing product types and to ensure that customer benefit is maximised from the IOSCO project.

## 5. **Roles and responsibilities - product provider and intermediary**

5.1 CIS (and equivalent products) may be sold either through a fragmented distribution chain (i.e. where the product provider and the distributor are different, unconnected persons (e.g. an investment bank which issues a note which is then sold through a financial adviser)) or through an integrated distribution chain (e.g. an insurance company which sells its own products through its own sales force). It will be necessary for the rules made in respect of POS disclosure to be applicable across both of these models.

5.2 We note that the Consultation Report acknowledges in Chapter V that it can be difficult to determine who is responsible for disclosure - the product provider or intermediary. The delivery of an appropriate outcome for the investor is generally a result of appropriate co-operation and interaction between the distributor and the product provider. Distribution chains vary considerably across product types and industry segments and the exact responsibilities of a firm must flow from the role it plays in the product delivery and lifecycle chain. The ultimate aim is to ensure that the customer is not treated differently in dealing with the fragmented distribution chain than he would be if he were dealing with an integrated producer/distributor. As noted above, the JAC Principles were formulated in order to clarify the roles and responsibilities of product providers and intermediaries.

5.3 We believe that more clarity in the IOSCO Principles around the roles and responsibilities of product providers and intermediaries for the key information disclosures is imperative. In many cases, the delineation of responsibilities between product provider and intermediary has been blurred and we would urge IOSCO to provide additional guidance to encourage better consistency in implementation. Broadly, the product provider can provide information on a generic basis in relation to the product itself whilst it will, invariably, be up to the distributor to provide any tailored disclosure to the ultimate investor. For example:

- (A) IOSCO Principle 1: further guidance would be helpful to clarify that, whilst the product provider can provide the information on the product itself, it is the intermediary which would provide and communicate any tailored disclosure to a specific investor.
- (B) IOSCO Principle 2: it is usually the intermediary which has the relationship with the ultimate investor and, therefore, any liability should be on such intermediary to obtain and retain appropriate proof that demonstrate that key information has been

delivered to investors. In addition, it would be helpful to include a time frame within which the investor can consider the relevant information.

- (C) IOSCO Principle 3: for structured securities, only the intermediary would usually be aware of individual investor characteristics and preferences and be in a position to deliver the relevant information to the investor directly. One comment received suggested the specific inclusion of websites as a means of communication.
- (D) IOSCO Principle 5: we note that there is a requirement for product providers or intermediaries to revise and update key information to reflect material changes (but that such information is not required to be delivered on an ongoing basis (post investment)). We would refer IOSCO to Principle 12 of Annex 2 in which the JAC acknowledges that distributors should provide financial advisors with the necessary information to help their clients monitor performance of any structured product in which they have invested and to provide certain information regarding the terms of that structured product.
- (E) IOSCO Principle 6: We do not believe that an intermediary should be in a position to alter any product information provided by the product provider. However, if there is agreement that an intermediary does alter or provide any tailored information, the onus should be on such intermediary to take responsibility for such changes.

## 6. Product disclosure

- 6.1 We welcome the development of the IOSCO Principles and we would highlight that a principles based approach allows different issues to be raised and highlighted in respect of different product types. In many respects this is desirable - an investor contemplating a choice between a CIS and a market-linked structured note should clearly understand the differences between the products, that they have different risk characteristics, and the different presentations used for the two different types of product should emphasise that distinction. For example, the elements required to give an investor a clear understanding of the risks associated with an investment will differ significantly according to whether the product described is a Contractual PRIP or a CIS. With this in mind, we note that Principle 4 requires a format for comparison to be included but we would urge regulators to acknowledge that those constructing the key information disclosure should be given some discretion in the way they present risks subject to an overriding requirement to do so in a way that is clear, accurate and not misleading to the target investor (IOSCO Principle 5).
- 6.2 In addition, IOSCO Principle 4 refers to plain language disclosure; the JAC would point out that in many instances the product provided to an end-investor is necessarily complex and the key disclosures required are not necessarily a simplification of a complex strategy but a clear outline in plain language of the risks inherent in the product.
- 6.3 In addition, to ensure consistent implementation across jurisdictions, it would be helpful to include examples and illustrations of the level and type of disclosure.

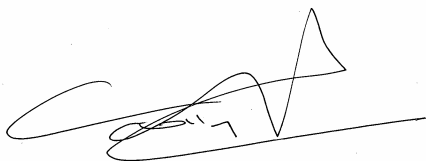
## 7. Fee and commission disclosure

- 7.1 Members acknowledge that CIS must be subject to a fee disclosure regime. This is because the fees concerned are deducted from the performance of the underlying assets and are, therefore, charged directly to the customer. For products of this kind, a customer cannot calculate his expected return on his investment unless he knows the level of such costs.
- 7.2 This is not generally true of Contractual PRIPs. A Contractual PRIP is a product which specifies to the investor exactly what he will receive at a future time. For such products there are no "costs" in the sense given above. For example, a deposit account customer

has no need to know what happens to his money once it is deposited - his entitlement to the return specified when he made the deposit is not affected by the question of what the bank concerned did with his money once it received it and whether such bank made or lost money with the proceeds of the deposit. The same is true for structured bonds.

- 7.3 Contractual PRIPs and CIS are priced differently. A CIS is a packaged offer of a service for a fee and the fees charged for the provision of that service are generally absolute and not performance related. Thus, what the investor will get as his investment return will be the investment performance less the management fees charged. He, therefore, needs to know the management fees charged in order to be able to work out what his investment return is likely to be. A Contractual PRIP, by contrast, will pay the defined return - fees and costs are already taken into account in the calculation of the return which is defined. The issue for the investor is as to whether the price which he is being charged for that return is cheap or dear, and he - or, usually, his investment adviser or broker can establish this by looking across the range of competing products and structures. A useful comparison can be made with bank deposits - an investor is not told, and does not need to know, the return which the bank hopes to make over its funding costs on the particular deposit.
- 7.4 What follows from this is that it is incorrect to regard a Contractual PRIP as a species of managed fund. The investor pays a price to receive a structured return, and the return he receives will be the return specified in the documentation. The profit or loss which may be made by the producer of the product is not analogous to the fees charged by a manager, since management fees are deducted from the return which the investor would otherwise have received, whereas product profits made or losses suffered are not. Consequently, disclosure of profit margins or losses on hedging is irrelevant to Contractual PRIPs.
- 7.5 This is a manifestation of the fact that it makes little sense to speak of comparing profitability even between different PRIPS. The fact that one institution has a different trading strategy from another, with a higher toleration of risk and therefore a higher prospect of return, is irrelevant to an investor choosing between the products of the two institutions. The key point is that the investor is unaffected by losses made on the hedge, in the same way and for the same reason that he does not participate in the gains. It is therefore seriously misleading to compare the profit made on hedging retail products with the management fee derived by a fund manager from his management activities. One is disclosed to the customer because it comes out of his pocket. The other is not because it does not.
- 7.6 There is, however, a considerable difference between profit margins made by distributors and inducements paid to distributors. This is because the latter are capable of creating conflict or bias, and the possibility of such bias should be disclosed to the client. We believe that the disclosure-based approach adopted (for example, in MiFID) is effective and is sufficient to deal with this issue.

Yours sincerely,



Timothy R Hailes

Chairman - Joint Associations Committee on Structured Products

# ISDA®



# ISDA®

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA (the International Swaps and Derivatives Association) was chartered in 1985, and today has over 800 member institutions from 54 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).



The International Capital Market Association (ICMA) is a unique self regulatory organisation and an influential voice for the global capital market. It represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers amongst its member firms. ICMA's market conventions and standard have been the pillars of the international debt market for over 40 years.

## ANNEX 1

**Retail Structured Products: Principles for Managing the Provider-Distributor Relationship<sup>2</sup>****A. Introduction**

These Principles seek to address issues that financial services firms have in practice found helpful to consider when performing the function of either provider or distributor in connection with the process of delivering structured products to retail investors.

It should be noted that **the Principles are non-binding and, as such, intended purely to help inform firms' thinking.** The sponsoring associations believe market participants should be free to agree their relationships and relative responsibilities on a case-by-case basis, to the extent these are not prescribed by local law or regulation. The Principles are intended to be sufficiently broad in their applicability to provide a reference framework for managing the provider-distributor relationship in retail structured products markets globally.

The Principles are the product of a global working group of firms, taking in the views of both distributors and providers and supported by a coalition of trade associations: European Securitisation Forum (ESF), International Capital Market Association (ICMA), International Swaps and Derivatives Association (ISDA), London Investment Banking Association (LIBA) and Securities Industry and Financial Markets Association (SIFMA). Furthermore, the associations issued the Principles for public comment, obtaining constructive feedback from other trade associations and market participants.

Structured products include a variety of financial instruments that combine various cash assets and/or derivatives to provide a particular risk-reward profile that would not otherwise be available in the market. The exact risk-reward profile varies from instrument to instrument.

The arrangements between the parties, the applicable regulatory regime and the fact that structured products combine various components may in practice result in different financial services parties being responsible for different aspects of the related regulatory obligations (even though the universal-bank model may entail a 'proprietary product distribution' arrangement). In particular, it is common for the distributor to have a direct interface with the retail investor while the provider does not. These Principles therefore particularly focus on how to address this issue, wherever it arises, given that all parties within this distribution 'chain' have a common interest in ensuring that investors obtain satisfaction with regards to their legitimate expectations as to the nature of the investment.

Retail investors in this context will mean natural persons and may include high-net-worth individuals. The Principles do not, unless otherwise indicated, address the role of entities acting solely as issuer of a product.

The Principles are drafted with no single jurisdiction in mind; they are, on the contrary, intended for global use, at a high level. The specific and possibly more detailed procedures that any firm might in practice (and subject to appropriate cost-benefit analysis) adopt to help it manage provider-distributor relationships with regards to retail structured products will be a function of factors such as the jurisdiction or jurisdictions involved, the distribution channel(s) utilised, the precise nature of the products and the nature of the relationship between the parties.

Regulatory treatment may depend on the nature of the component instruments; for instance, depending on the jurisdiction, structured deposits or exchange-traded notes acquired by investors

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<sup>2</sup> Published in July 2007

via brokers on a 'reverse-enquiry' basis may each require separate analysis. Among other matters, due consideration will need to be given to post-sale arrangements such as secondary market-making activity and information provision. The sponsoring associations invite industry to consider adapting the Principles, as appropriate, to take account of such specific factors.

## **B. Principles**

**These Principles should be read in conjunction with the Introduction above, which contains important overarching comments on the nature and scope of the Principles. Moreover, the Principles are to be taken collectively, rather than viewing any one Principle in isolation from the others.**

1. Distribution to the retail investor in structured products in many, though not all markets, is effected through intermediaries, e.g. private banks, rather than directly by the product 'provider' (sometimes referred to as 'manufacturer').
2. Where a product provider and a private bank (or other retail-facing business) operate within the same institution, they may operate quite distinctly; they may even be subject to different regulation; or have different reporting and management structures. Any such formal separation is generally robust and will be driven by legal, compliance, confidentiality and other requirements. Thus, even where a product is originated and distributed by the same institution, there can, in practice, be a separation between the manufacturing and distribution functions to which these Principles refer.
3. Product providers should consider what internal approval processes are appropriate for retail structured products; any such processes might address such issues as sign-off, product structuring, risk-reward and distribution.
4. The distribution structure means that it is often the distributor who interfaces with the individual investor and whose client that investor is. In such circumstances, investor suitability (as determined in the local market) is accordingly exclusively an issue for distributors, since it must be considered in the context of confidential information provided by the client to the distributor.
5. Distributors must understand the products they distribute. In jurisdictions where distributors provide not only the issuer's prospectus document but also term-sheets or other marketing material (such as brochures) to their clients, the distributors take responsibility for the accuracy and completeness of those marketing materials, even if they incorporate material provided by the product provider; in these circumstances, a distributor must be satisfied with and take responsibility for such materials and their compliance with local law and regulation.
6. Product providers should ensure that their term-sheets are accurate, fair, balanced and clear (respecting, as appropriate, jurisdiction-specific regulation to this effect); and that they are presented in a way which is consistent with their agreed obligations to the distributor. (For example, where the parties understand that the product will be distributed by the distributor to high net worth individuals, the termsheet should not contain rubric that the product is not suitable for retail investors.) Where providers agree to assist the distributor by supplying information, this should be clear and of the kind requested by the distributor in preparing its own term-sheet or product description for its client; this may include scenario analyses and relevant-to-product risk factors.
7. When commencing dealings with a distributor, product providers should consider whether the distributor is an appropriate distributor for the placing of particular types of products and, where they consider it necessary, practical and appropriate to do so, should conduct a "know your distributor" approval process. There is no fixed form for this process, which can vary according to the circumstances, and there are a number of means by which a



provider can gain comfort as to the integrity of a distributor's processes. Issues which may typically be considered include a distributor's typical client type (and whether the distributor deals directly with them or via sub-distributors), suitability determination processes, regulatory status, reputation and compliance with selling laws; though the specific details considered will vary widely depending on the distribution, the particular product and the relevant jurisdiction or jurisdictions. Each party does, in any case, retain its own regulatory obligations; no party takes on the regulatory obligations of another or the oversight of that other party's compliance with those obligations.

8. Distributors should also evaluate product provider counterparties ("know your product provider"), particularly as regards the product provider's performance with respect to those items mentioned in 6 above.
9. To the extent that law and regulation may not distinguish sufficiently between the roles of product providers and distributors, this may create points of uncertainty as to where legal or regulatory liabilities may fall. Providers and distributors should be aware of this and its consequences.
10. Product providers and distributors should seek to agree and record their respective roles and responsibilities towards investors.

## ANNEX 2

### Structured Products: Principles for Managing the Distributor-Individual Investor Relationship<sup>3</sup>

The distributor-individual investor relationship should deliver fair treatment of the individual investor. Individual investors need to take responsibility for their investment goals and to stay informed about the risks and rewards of their investments. Distributors can play a key role in helping them achieve these objectives. In this document, an "investor" means a retail investor who is not an institution, a professional, or a sophisticated investor, and a "distributor" refers to any institution or entity that markets or sells retail structured products directly to an individual investor. This will include an issuer of a retail structured product that markets or sells the same directly to individual investors.

In light of the increased interest in structured products as part of individual investors' investment and asset allocation strategies, it is important for firms to keep these principles in mind in their dealings with individual investors in structured products. These principles complement and should be read in conjunction with our recently released, "Retail Structured Products: Principles for Managing the Provider-Distributor Relationship," available at the websites of the five sponsoring associations<sup>4</sup>, which focus on the relationship between manufacturers and distributors. These principles apply to the relationship between the distributor and the individual investor.

Although these principles are non-binding (being intended primarily to help inform firms' thinking) and do not create enforceable obligations or duties, firms involved in the distribution of structured products to individual investors are encouraged to reflect these principles in their policies and procedures. Further, each firm is encouraged, given differing regulatory environments and both cultural and client base differences, to consider the extent to which the firm should adapt these principles to its particular circumstances. As stated in the related Provider-Distributor Relationship Principles noted above (Principle 7), "no party takes on the regulatory obligations of another or the oversight of that other party's compliance with those obligations."

For the avoidance of doubt, these principles are intended primarily to apply in the context where structured products are actively marketed and/or recommended by distributors to individual investors, and not where distributors are merely executing transactions for investors on a non-advised, non-discretionary basis. Where distributors are executing on this basis, those parts of these principles that are not appropriate to such relationships (for example, those relating to secondary market making and client appropriateness and suitability) shall not apply.

#### **Overview**

The term "structured products" refers to a variety of financial instruments that combine various cash assets and/or derivatives to provide a particular risk/reward profile that allows investors access to broader investment opportunities. The return of a structured product is usually derived from the performance of one or more underlying assets. Examples of underlying assets include, but are not limited to: interest rates; a particular equity or debt instrument; a basket of securities; a securities index or indices; an individual commodity or commodities; a commodities index; an individual currency or currency basket; creditworthiness of a security or basket of securities; or any combination thereof.

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<sup>3</sup> Published in July 2008

<sup>4</sup> European Securitisation Forum, International Capital Market Association, International Swaps and Derivatives Association, London Investment Banking Association, Securities Industry and Financial Markets Association

Some structured products offer full or partial principal protection, while others have no principal protection. Some offer a yield; others do not. It is possible that the value of an individual structured product may not increase as much as the underlying asset, or may decrease more than the underlying asset. Some structured products offer individual investors access to new asset classes that may otherwise be difficult to access through other investment alternatives and which can help with portfolio diversification.

Structured products can be more or less risky than other investment products such as equities, fixed income products, or mutual funds: there is no necessary link between product complexity and investment risk - complex products may be low risk, and non-complex products may entail high risk. It is important that an investor understands the role in an investment strategy that can be played by any particular structured product in light of the investor's specific investment objectives, risk tolerance, and investment horizons.

## **Principles**

These Principles should be read in conjunction with the Overview and Introduction section set out above, which contains important overarching comments to the nature and scope of the Principles. Moreover, the Principles are to be taken collectively, rather than viewing any one Principle in isolation from the others.

### **1. Product Transparency**

The party who is primarily responsible for the creation of marketing materials,<sup>5</sup> or is responsible for a prospectus, or other offering memorandum, should, to the extent permitted by applicable laws and regulations<sup>6</sup>, use reasonable efforts to ensure that the material features of the particular structured product are clearly articulated and delineated in such marketing materials or prospectus in a way that enables individual investors to evaluate the investment from a risk/reward perspective. Such party should also ensure that structured product descriptions in client materials and prospectuses are clear and not misleading. This will be helpful to both individual investors' and financial advisors'<sup>7</sup> understanding of the product. Further, to the extent that a distributor is primarily responsible for the creation of marketing materials, such materials should be adapted to, and reflective of, the knowledge and sophistication of individual investors in the target market. For example, it should be clearly disclosed how returns on a structured product are linked to an underlying asset.

Marketing materials that are distributed to, or intended for distribution to, individual investors should be subject to review by the distributor's appropriate supervisory staff, as well as other internal processes, such as compliance or legal, as appropriate.

### **2. Risk Disclosure**

Risk disclosure is important to an investor's understanding of structured products and should be made available to investors before a decision to invest is made. Investors should understand the risks inherent in the product before investing in it. Investors should be informed of the general types of risks associated with structured products, subject to individual regulatory standards as to the specific language required. Particular prominence should be given to any risk not usually associated with a given product, for example, risk of loss due to any sale of the product before

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<sup>5</sup> The relationship between providers and distributors is specifically addressed in "Retail Structured Products: Principles for Managing the Provider-Distributor Relationship," Principle 5, Joint Trade Associations, July 2007.

<sup>6</sup> In some jurisdictions, law and regulation may specify or limit the form, the content or the presentation of material which may be given to investors. These principles do not require such rules to be disregarded.

<sup>7</sup> "Financial advisor" refers to the firm's employees, or independent contractors, who interact directly with individual investors and who are registered to solicit trades and effect transactions. The formal term may vary significantly by firm and/or jurisdiction.

maturity, as well as any material product-specific risk that may apply, such as risks arising from the underlying asset, liquidity and market risks in relation to the product itself, or specific tax considerations. Where information on past performance is given, the presentation should be fair and not misleading, and, in particular, should acknowledge any limitations in available data.

### **3. Fees and Costs**

Investors in a structured product should be informed of the existence of fees, costs, commissions, discounts, and any other sums paid to the distributor for acting as such over the life of that product. Distributors should have internal processes and controls in place to consider the appropriateness of fees and other incentives given local market conditions and regulatory requirements. A distributor's internal processes and controls should also consider the level of disclosure regarding such fees and costs in light of their possible impact on the secondary market of the structured product concerned.<sup>8</sup>

### **4. Potential Conflicts Management**

Distributors should have internal processes and controls in place to consider potential conflicts issues and identify measures designed to mitigate, manage, or disclose material conflicts of interest arising from the sale of structured products. Such processes should, where necessary or appropriate, provide timely, adequate, and clear disclosure related to conflicts of interest or potential conflicts of interest that may exist or arise in connection with the distributor's sale of the structured product, or as a result of the business they conduct.

### **5. Credit Ratings**

Credit ratings of issuers or, where applicable, guarantors, may not represent a rating of the potential investment performance of the individual structured product itself. Credit ratings, however, should be taken into account to the extent that it affects the terms of the product. If credit ratings are provided, the related disclosure should make clear the significance of the rating. Distributors should use credit ratings accordingly.

### **6. New Product Review**

Distributors should understand the products they distribute. New structured products, whether developed by the distributor or developed by a third-party provider or manufacturer, should be subject to the distributor's product review and assessment process. This process should take into account the nature of the new structured product, the target investors, and an assessment as to whether the product is appropriate for its intended target market. Distributors should also have a process for determining what generally constitutes a "new product." It is not sufficient for a distributor to accept a third-party manufacturer's assessment regarding appropriateness of structured products for individual investors who are ultimately customers of the distributor and not the manufacturer. Distributing firms should conduct an independent assessment.

### **7. Liquidity/Secondary Market**

Investors should be informed before investing of the likelihood of their being able to sell a particular structured product prior to maturity, and of the ways in which this might be done. Any secondary market to be provided by the distributor itself or through an exchange, or otherwise, should be disclosed. If there is little likelihood of such sale or other liquidation being possible, that fact should be clearly disclosed. Investors should be made aware that sales in the secondary markets, even where possible, may be at prices that are below the amount payable on the product at maturity, the original offering price, or the price at which they acquired the product. In addition, distributors should make a clear distinction between an investment in the structured product and a direct investment in the underlying asset, and that the return on the structured

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<sup>8</sup> Insofar as a secondary market exists for the product. See Principle 7.

product may not reflect the return of a direct investment in the underlying asset, noting in particular that these respective returns may not necessarily move in tandem. For principal-protected products, it should be made clear to investors that the principal protection applies only at maturity, and the costs of unwinding the product mean that an earlier redemption value may differ materially from the potential value at maturity.

#### **7a. Client Valuations**

Structured products should be valued on a regular basis and disclosed to the investor through the distributor's normal client statement process or otherwise.

#### **8. Client Appropriateness and Suitability**

Where a firm actively markets a particular product, as opposed to merely executing transactions on clients' instructions, it should determine which particular types of clients the product could properly be sold to (appropriateness) and may also be required to determine whether the particular product is right for a particular client (suitability). Methodologies and standards for making these determinations should be developed by the distributor and adequately communicated to the distributor's financial advisors. Liquid net worth, degree of sophistication, risk profile, age, and investment experience are several variables that may be relevant to such an assessment. Also, financial advisors should consider how a specific structured product would fit into an individual's portfolio. These standards should be reviewed periodically and amended, as needed.

#### **9. Financial Advisor and Supervisor Training**

Structured products vary a great deal as to their terms, risk/reward profile, liquidity/availability of a secondary market, underlying asset, and a variety of other factors. As such, it is important that financial advisors interacting with individual investors have an adequate understanding of structured products in general as well as an understanding of the characteristics of the individual structured products being offered. The financial advisor should be able to clearly explain the product's features to an individual investor. Distributors should provide their financial advisors with the necessary training, or access to training, in structured products, including both the benefits and risks of the products, and should consider providing educational materials on structured products generally, in a suitable form (including one-on-one meetings, written materials, class-based training, desktop training, or other forms, as appropriate). Such training should also be provided to those responsible for supervising financial advisors.

#### **10. Oversight and Compliance**

Structured product sales to individual investors should be subject to the distributor's internal legal, compliance, and supervisory review processes, policies, and procedures. Distributors should have such supervisory procedures in place covering transactions in structured products, which should involve supervisory staff of appropriate seniority in light of the nature of the particular product and investor target market. Supervisory responsibilities may encompass sales practices, reasonableness of profit/loss potential, fees, and adequacy of training. Managers performing such supervision should have access to appropriate legal and compliance department support.

#### **11. Tax Implications**

Investments in structured products may have tax consequences for individual investors depending on their personal circumstances and jurisdiction of residence. Although certain tax implications may be highlighted in product documents, investors should be encouraged to discuss the specific tax implications of structured products with their accountant, tax attorney, or other tax professional.

## 12. **Post-Trade Follow-up/Product Life Cycle Issues**

Distributors should provide financial advisors with the necessary information to help their clients monitor performance of any structured product in which they have invested, and provide access to information regarding the terms of that structured product, including its maturity, pay-out details, secondary market price,<sup>9</sup> and other pertinent information.

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<sup>9</sup> Insofar as a secondary market exists for the product. See Principle 7.