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**BY [POST/EMAIL]**

13 June 2013

Dear Sir

**JAC Response to the IOSCO Consultation Report: Regulation of Retail Structured Products  
(the "Response")**

This paper responds to the IOSCO Consultation Report: Regulation of Retail Structured Products (the "**Consultation**") which has been prepared in order to better understand and analyse trends and developments in the retail structured product market and develop guidance where appropriate. The Joint Associations Committee on Retail Structured Products (the "**JAC**")<sup>1</sup> welcomes the opportunity to comment on the issues set out in the Consultation. We agree with the objective of understanding and analysing the trends, developments and related regulatory issues encountered by IOSCO members in relation to the regulation of retail structured products and fully support an appropriate and proportionate regulatory approach to develop guidance to achieve this objective.

The members of the JAC comprise a large proportion of the major firms involved in the creation, manufacturing and distribution<sup>2</sup> within the EU of retail structured products<sup>3</sup>. The Consultation, based on a survey of IOSCO members carried out in mid-2012, covers and the JAC focuses on the structured products market, the current regulatory framework, regulatory drivers and regulatory effectiveness.

We consider that the proposals set out in the Consultation might also be considered in light of:

- the JAC Principles "Retail Structured Products: Principles for managing the provider-distributor relationship" ("**JAC Principles**"). The JAC Principles seek to address issues that firms have in practice found helpful to consider to ensure good consumer outcomes when performing the function of either provider or distributor in connection with the process of delivering structured products to retail investors. The JAC principles that apply to the distributor-individual investor relationship, i.e. the Structured Products: Principles for Managing the Distributor-Individual Investor Relationship ("**JAC Distributor Principles**"). These sets of principles are highly relevant to the proposals set out in the Consultation and we refer to the JAC Principles and JAC Distributor Principles where appropriate in this Response. The JAC Principles and JAC Distributor Principles are set out at Annexes 1 and 2 to this Response.

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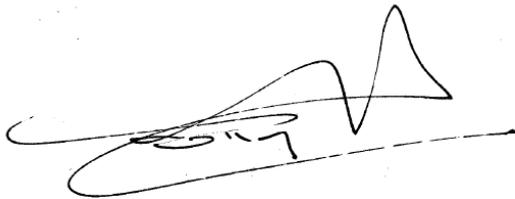
<sup>1</sup> The JAC is sponsored by multiple associations with an interest in retail structured products. In the first instance, queries may be addressed to [BGourisse@isda.org](mailto:BGourisse@isda.org)

<sup>2</sup> In this regard, distribution is primarily carried out by members of the Structured Products Association.

<sup>3</sup> This paper represents the views of members of the JAC with regard to the regulation of retail structured products in the UK and EU. As such, this paper should not be taken to represent views regarding retail structured products in any other jurisdictions.

While the JAC members generally agree with many elements of the proposed regulatory toolkit in the Consultation, there are a number of significant qualifications from both a consumer benefit and an industry perspective. This paper seeks to highlight these issues, with the hope that this will be helpful in informing the development of regulatory tools and ensure the best possible outcome for both consumers and the retail structured product market. We would be very happy to provide further input on any of the below points if that would be of assistance and would welcome the opportunity to engage further with IOSCO on this topic.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Timothy R Hailes', written over a horizontal dashed line.

**Timothy R Hailes**  
Chairman, Joint Associations Committee

**Issue 1 for consultation:**

- 1.1 Do you think the survey results accurately reflect the regulation and markets of the respondent jurisdictions?**
- 1.2 Are there any other relevant facts, regulations or dynamics that the Working Group should consider?**

- 1.1 Generally, the JAC members are of the view that the survey results accurately reflect the regulation and markets of the respondent jurisdictions.
- 1.2 The JAC members would support a more standardised approach to defining ‘retail investors’; namely an approach which distinguishes between ‘true’ retail investors (e.g. individual clients of high street retail banks) and sophisticated and/or high net worth investors (e.g. clients of private wealth banks), and which provides appropriate and proportionate levels of protection to each. Individual retail investors will vary greatly in their level of understanding of markets, and there will be similar variations between individual non-retail investors. Some retail investors will have a high degree of sophistication, experience, knowledge and capability, whereas others will have a much lower degree. Investors of a similar level of actual sophistication or capability should be afforded a similar, appropriate minimum level of protection.

The JAC members would also suggest that IOSCO consider this Consultation and the responses to it in light of the current initiatives on Packaged Retail Investment Products (PRIPS) at European level. The PRIPS initiative is aimed at achieving consistent and effective standards for investor protection across a wide range of investments and to ensure that there is a level-playing field for distributors and providers of investment products. As there is a significant degree of overlap between the issues raised in the Consultation and those raised in the PRIPS initiative, the JAC members suggest that IOSCO may wish to delay any action as a result of this Consultation until the PRIPS regulation is in force and its implications can be seen in practice.

**Issue 2 for consultation:**

- 2.1 Do you believe that inter-or intra-jurisdictional regulatory arbitrage is an issue within the retail structured product market where there is an integrated market? Why or why not? What if there is not an integrated market and different regulators within jurisdictions are involved? If so, do you think that the regulatory tool proposed above will help to address the issue? What alternative measures could IOSCO members consider?**

**2.1 *Jurisdictional arbitrage***

Whilst differing regulatory regimes continue, there is a risk that they may be arbitrated, with certain market participants potentially seeking to structure products so as to minimise their regulatory obligations. In order to ensure consistency in relation to the sale of structured products, the JAC members welcome the introduction of standards determined at an IOSCO level to facilitate the development of a level playing field across jurisdictions. In particular, the JAC members would welcome a harmonised approach across, for example, the EU to avoid cross border arbitrage and/or gold plating by individual countries. Even where there is not an integrated market, where institutions are operating on a global basis and originating products for a number of jurisdictions, it would be helpful to have a

consistent set of provisions which regulators could apply and JAC members would urge regulators to adhere to such standards and avoid imposing additional, national regulations which potentially lead to market participants exiting the market and reducing the range of products that are offered.

### ***Client categorisation***

We believe that it would be helpful to develop common global standards on client categorisation and to harmonise and provide a clear definition of the scope and nature of retail investor, as discussed at paragraph 1.2 above.

It is noted in the Consultation that in the vast majority of respondent jurisdictions, there is “*no positive (legal) definition of ‘retail investor’*”. For the purposes of the Consultation, structured products<sup>4</sup> are considered ‘retail’ when sold to retail investors or customers, to be generally identified or defined on a jurisdiction-by-jurisdiction basis. The JAC members would support a more uniform approach which distinguishes between ‘true’ retail investors and sophisticated and/or high net worth investors and which provides appropriate and proportionate levels of protection to each.

However, irrespective of the classification of the client, nothing should detract from the responsibility of all investors, once they have received suitable advice and appropriate disclosures from a distributor or have chosen not to seek advice, to evaluate any information provided to them, educate themselves about the products they undertake and ultimately take responsibility for the risks of their choices.

#### **Issue 3 for consultation:**

- 3.1 Do you think that it would be useful for IOSCO members to take a value-chain approach to retail structured products?**
- 3.2 What issues do you think members could encounter in pursuing such an approach? How could those issues be overcome?**

### ***Value chain approach***

- 3.1 Before responding to the issues raised here, the JAC members consider that it is important to explain what is meant by the ‘value-chain approach’. There is no single framework for the process by which an investor will obtain an investment exposure in which product providers and distributors always play the same roles; rather, the process commonly involves a series of stages, some of which will be the domain of the product provider and others that of the distributor and, in some cases, both. Any ‘value-chain approach’ should take this diversity fully into account and allocate regulatory responsibility appropriately and proportionately. On this basis, the JAC members generally support the proposal that a value-chain approach should be taken in relation to retail structured products provided that there is an acknowledgment that there are different roles and responsibilities undertaken by different parties within the ‘value chain’. This would help strengthen regulatory control over the retail structured products market as a whole and provide consistency in the approach being adopted in different jurisdictions.

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<sup>4</sup> Structured products are defined, for the purposes of the Consultation, as “*compound financial instruments that have the characteristics of combining a base instrument (such as a note, fund, deposit or insurance contract) with an embedded derivative that provides economic exposure to reference assets, indices or portfolios. In this form, they provide investors, at predetermined times, with payoffs that are linked to the performance of reference assets, indices or other economic values.*”

As products may either be sold through a fragmented distribution chain (i.e. where the product provider and the distributor are different unconnected persons) or through an integrated distribution chain, it is necessary that any approach to the value-chain takes this into account. The delivery of an appropriate outcome for the investor is generally a result of appropriate cooperation and interaction between the distributor and the product provider. Distribution chains vary considerably across product types and industry segments and the exact responsibilities must flow from the specific roles of the product provider and the distributor. It will, therefore, be necessary to distinguish between issues that relate to the conduct of business of the relevant distributor (e.g. conflicts, inducements, suitability) and those which relate to the product itself. Product providers cannot deliver requirements which relate to the conduct of the distributor selling the product and it is important that any such approach does not impose such obligations.

- 3.2 The JAC members take the view that whilst a product provider should bear responsibility for ensuring the product "does what it says on the tin" (i.e. performs in accordance with the methodology and formulae outlined in the documentation), it is the distributor who should take responsibility for the wider product governance. Ultimately it remains the case that it will be for the distributor to determine whether a product is suitable for an end investor, following the product provider's general assessment of the product against the target market. It is the distributor rather than the product provider who can control who a product is distributed to.

We would therefore urge the regulators to bear in mind the method of origination for determining product features when creating and allocating regulatory obligations, and also when exercising supervisory and enforcement powers; the person or persons who undertake product design should bear responsibility in relation to the design of the product to meet identified consumer needs and the distributor should continue to bear point of sale responsibilities.

The JAC members are also of the view that any such approach should differentiate between (a) reverse enquiry scenarios (where the distributor will, in most cases, have pre-defined the key terms of the product (including the pay-off, wrapper and the underlying) and the product provider will design the structured product which meets those requirements) and the position where an entity provides only a component part of a retail structured product and hence may be a "pure manufacturer" only, where responsibility may lie with a different entity within the value chain and (b) the position where the product provider is designing the product from the outset and then engaging distributors for marketing purposes.

**Issue 4 for consultation:**

- 4.1 Do you think that IOSCO members (that have the legal framework that would permit them to do so) could make issuers consider improvements to their market assessment process in light of their findings (where market assessments are required)?**
- 4.2 What do you consider to be the role of IOSCO members in the development and sale of retail structured products?**

- 4.1 The consultation refers throughout to the term 'issuer' and notes that for the purposes of the Consultation, 'issuance' encompasses "*the issuance, origination or manufacture of retail structured products*", with 'issuer' accordingly having a similarly broad meaning. The term 'issuer' needs to be considered carefully and the JAC members would suggest the use of the term 'provider' (as used in the JAC Principles) instead. As noted above in paragraph 3 and

below, the entity which carries out the structuring, design and market assessment (i.e. identification of the target market) process may not necessarily be the ‘issuer’ of the relevant product and this distinction is important when allocating responsibility within the value-chain. There are certain examples where the structuring of the product is extensively performed by someone other than the issuer. Further, it is likely, in the case of a ‘reverse enquiry’ or ‘counterparty’ scenario, that the entity which carries out the market assessment process will be the distributor and as such, responsibility should be allocated to them.

### ***Market assessments***

As noted above, where appropriate, we agree that responsibility should be placed on product providers to consider improvements to the market assessment process.

Product providers should be required to analyse and evaluate the target investor segment’s needs and design a product to meet those needs. They should also be required to describe the product in a way most likely to be understood by the target investor segment profile. However, the JAC members take the view that it is the distributor’s role to ensure that products are distributed to investors for whom they are suitable and appropriate. It is most unlikely that a product will be suitable/appropriate for all of a distributor’s clients, even where it has been developed with a particular sector of the market in mind which is serviced by a given distributor. As it is the distributor that has the direct interface with the individual investor, investor suitability/appropriateness of a product is a matter for distributors only and is not a role that the product provider can play.

The JAC members would urge regulators to be very clear about the delineation of responsibilities between product providers and distributors. In particular, in relation to what the “market assessment process” should entail, especially when carried out by a product provider that is not a distributor.

### ***Development and sale of retail structured products***

- 4.2 In relation to the specific requirements proposed by IOSCO, we would note that whilst the JAC members agree that product providers should have in place rigorous processes for the internal control of product origination and approval, responsibility for promotion of the product and investor education should generally be carried out by the distributors. In addition, in order for a product provider to be in a position to analyse the target market, distributors will need to provide them with the relevant management information to carry out such analysis.

#### **Issue 5 for consultation:**

- 5.1 Could the use of modelling as contemplated by this regulatory tool have an impact on the production of better value products and products that perform as intended or better disclosure? If yes, why? If not, why?**
- 5.2 What are the risks with using modelling as contemplated by this regulatory tool? Do you think investors would benefit from having access to the results of the modelling? Could IOSCO members require issuers to provide other information on the potential performance of the product? Please explain.**

## *Modelling*

- 5.1 The JAC members support a principles-based approach to modelling in this area. The JAC members' general view is that any modelling should be generic in nature and not tailored to a specific investor. The relevant firm could apply general principles to the context of a particular product to determine what types of analysis would be appropriate. The diversity of product offerings makes it impracticable to impose an overarching rule.

The JAC members would suggest that the focus for the product provider should be on forward looking scenario analysis and/or a clear explanation of the product and all the possible outcomes rather than attempting to predict how indices or other reference points to which the product is linked will perform.

- 5.2 The regulatory tool proposed in the Consultation envisages the possibility of using modelling to 'stress-test' the product and providers being required to disclose the results of the modelling to investors. Whilst the JAC members generally agree that modelling is helpful in the design and structuring phase and allows the performance of the structured product to be simulated, a requirement to 'stress-test' products should not be mandated, nor should the disclosure of modelling to investors. Were this approach to be followed, there is a risk that investors could be misled if misinterpreted assumptions are used in the model and investors may place undue reliance on the results of the modelling.

### **Issue 6 for consultation:**

#### *Internal approval process*

- 6.1 Do you think that a mandated internal approval process for issuers is warranted, or do most issuers already have this process in place? If the issuers already have such an internal approval process in place, how could it be improved? What should be the key elements in such an internal approval process? How effective are internal approval processes in vetting products before they are issued?**

#### *Regulatory pre-approval*

- 6.2 Do you think it appropriate that regulators pre-approve products before they can be issued? Does the Consultation Report correctly describe the benefits and risks of such a process? If not, what are the benefits and risks? What do you think should be the criteria, standards and requirements for approval by the regulator? Please provide reasons.**

#### *Internal approval process*

- 6.1 The JAC members would highlight Principle 3 of the JAC Principles which requires product providers to consider what internal approval processes are appropriate for retail structured products including sign-off, product structuring, risk-reward and distribution.

In addition, the JAC members would generally also operate within a corporate culture which reflects reputational risk to the institution as well as more generally a value control process on risk/reward in relation to products targeted at retail investors. Therefore, the JAC members would expect product providers to have detailed processes and procedures in place for approving new retail structured products, in order to ensure that the product approval process is not compromised as a result of commercial, time or funding pressures. In our view, the vast majority of issuers already have detailed processes and procedures in place for approving new retail structured products.

The process would generally also allow for review and challenge by the risk and compliance functions so that the entire product governance process reflects balanced values across all functions and is not compromised by interests of the business.

The JAC members would like to reiterate that in many cases it is the distributor or overall product provider which will need to carry out the more lengthy product approval process and business models analysis and not the "pure" manufacturer or counterparty.

### ***Regulatory pre-approval***

- 6.2 The JAC members are of the view that there should not be a regulatory product pre-approval process. We believe that this would present moral hazard for the regulators as well as creating unnecessary inefficiencies.

We agree with the view expressed by some IOSCO members that there is a risk that a pre-approval process may mean retail investors capable of understanding the relevant investment risks will miss relevant investment opportunities. Investors may also assume that if the regulator has 'signed-off' a product, they have less responsibility in informing themselves about a proposed investment. We believe that a market-wide pre-approval approach may stifle innovation and restrict customer choice by too great a degree.

Were pre-approval processes introduced, we agree that they would need to be administered by individuals who understand how structured products work from a financial perspective and the requirements the products need to comply with. Given the number of products in the market and the frequency of product changes and variations, this would have massive resourcing implications for the regulators, and as a consequence, costs which are likely to be passed back to firms and ultimately consumers.

In addition, it should be noted that structured products are already regulated under the Prospectus Directive and the UCITS Directive, or other analogous regimes in other jurisdictions, in relation to disclosure, form and content.

### **Issue 7 for consultation:**

- 7.1 Do you think it appropriate that regulators play a role in setting product standards for retail structured products?**
- 7.2 If regulators do set such criteria, how should they do this, and what are the risks to the regulator and the market?**

### ***Product standards***

- 7.1 We would refer back to the "moral hazard" such as set out in paragraph 6 above. JAC members would suggest that a more effective approach which recognises the different participants within the value chain is a detailed internal product approval regime coupled with disclosure to the investor, a suitability assessment by the relevant distributor and investor education. Appropriate retail structured products should be offered to the investor only once these processes have been completed. The imposition of structural product standards without extensive consideration and consultation could have unintended consequences. For example, the Consultation suggests that a minimum capital level for product providers may be a suitable standard; such a requirement would have a significant impact on certain structures which typically have limited capital and increasing the capital requirement would affect the cost to the investor without a clear rationale.

A well-designed system of internal controls should include a process to periodically reassess complex products in order to determine whether their performance and risk profile remain consistent with the manner in which they are being sold.

If regulators are to play a role in setting product standards for retail structured products, the JAC members are of the view that it is key that such intervention is impact assessed, proportionate and targeted appropriately.

- 7.2 If regulators do intervene and set product standards, we suggest that they take into account the heterogeneity of origination processes and in particular responsibility for determining product features when creating and allocating regulatory obligations around product origination, and also when exercising supervisory and enforcement powers.

Any product intervention which requires changes to products would need to be considered carefully and it would be important to distinguish between whether the underlying instrument, the provider or the distributor is at fault before any intervention is made and where that intervention should be directed.

**Issue 8 for consultation:**

- 8.1 How prescriptive is it appropriate for IOSCO members to be in setting issuer disclosure standards? What topics or items could benefit from specific explanation requirements?**
- 8.2 Do you think that risk indicators or minimum information requirements are useful? If so, what should the indicators or requirements be? How else could disclosure to investors on retail structured products be improved? Is there any disclosure that should be prescribed or proscribed?**

*Disclosure standards*

- 8.1 The JAC members agree with the overall aim of enhancing the transparency of retail structured products in order to seek to ensure that retail investors have a greater understanding of complex structured products and the risks associated with each product. We agree that information about financial products in the marketing or pre-contractual material should be clear, fair and not misleading. However, we refer back to our responses under Issues 3 and 4, namely that it is the distributor that has the direct interface with the individual investor and it is the responsibility of the distributor to ensure that the investor has all the requisite information in order to make an informed decision. The product provider is not likely to have sufficient information in order to make disclosures which are consistent with the investors' capacity to understand such disclosures.

The JAC members support the use of a glossary of terms which may be helpful for investors on a global basis and would provide an explanation of more specialist terms, allowing the main body of the pre-contractual material to be less 'cluttered' and more retail-friendly. It would also assist in improving the understanding of less sophisticated investors, in line with the wider investor education goals discussed under Issue 14.

Such a glossary could be prepared by product providers/distributors on a house-by-house basis or subject to some form of IOSCO-led standardisation where appropriate. Standard form definitions could be developed for certain common terms. The JAC members would be happy to work with IOSCO on any such project.

### *Risk indicators*

- 8.2 Investors tend to place undue emphasis on a risk indicator. This is a particular concern in the context of certain retail structured products where the risk profile is diverse including credit risk of the product provider (in particular, given the additional obligor credit risk dimension). A single figure rating is overly simplistic and discourages investors from fully engaging with the detail of this risk profile.

The JAC members also generally agree that when developing indicators it is important to distinguish between indicators that are intended to give the investor insight into the risks involved and indicators that aim to give insight into the product's possible return.

Diverse risk profiles often apply to retail structured products and risk is often investor specific. For example, an investor investing in a product denominated in a currency other than that of his home member state takes significant foreign exchange risk which may not be factored into the indicator. Consequently, narrative risk explanations are far more useful to investors allowing them to assess the relevance of each risk factor identified in the context of their specific portfolio.

There are concerns that, in the context of highly complex but relatively low risk products (e.g. complex structuring might be used to reduce risk), an inappropriately designed indicator may incorrectly score these products as higher risk due to their complexity.

To some degree, all financial products are complex and complexity can result in misleading views about a product. It is important to distinguish between inherent product complexity and complexity that is introduced to exploit consumers. Although some products may be complex, they will be suitable for some investors. It does not follow that a product with a relatively complex legal structure will also have a complex risk/reward profile (or vice versa). As a result, it should not be assumed that complexity of a product equates to a higher risk or to a narrower suitability.

The JAC members also agree that standardised disclosure leads to boilerplate language that is not useful to investors.

<b>Issue 9 for consultation:</b>	
<b>9.1</b>	<b>Do you think it appropriate that IOSCO members mandate or encourage short-form or summary disclosure? Would such disclosure be helpful to investors in understanding the products that they are purchasing? What are the risks associated with such disclosure?</b>
<b>9.2</b>	<b>At what point in time should investors be provided access to this disclosure and what responsibility should the issuer have with respect to the content of the disclosure?</b>
<b>9.3</b>	<b>What information do you believe IOSCO members could require to be included in a short-form or summary disclosure?</b>
<b>9.4</b>	<b>If IOSCO members require the use a short form or summary disclosure, should this disclosure allow comparisons across products and, if so, what products should be able to be compared?</b>

### *Short-form disclosure*

- 9.1 We agree with the introduction of a short-form disclosure regime as we believe that it would be of assistance to retail investors embarking upon their decision-making process, and as such will act as a further important risk mitigant against mis-selling of products.

However, the focus must be on ensuring that this document is designed to provide a high standard of summary disclosure, and does not inadvertently undermine other product literature which retail investors already find useful. Regulators should bear in mind that attempting to over-simplify product information, focusing on brevity at the expense of quality, and attempting to put disclosure into an inappropriate framework will severely limit the usefulness of the disclosure and is likely to result in the document misleading investors. The interplay between any short-form disclosure document and other contractual/disclosure documentation is very important. Any short-form disclosure document will not, on its own, form a sufficient basis for investor decision-making and should cross-refer to other contractual/disclosure documentation.

Any short form disclosure document should be designed to assist an investor in engaging with and understanding the legal terms and conditions of the products and the implications of the terms and conditions in terms of investment proposition, risk, reward and charges. Investors would still be expected to read the other documentation provided to them when making their investment decision (or be advised by someone who has) and be bound by their terms.

It is important that there is consistency across jurisdictions where possible and we note the EU PRIIPS regime (as discussed in paragraph 1.2 above) under which a harmonised short form disclosure regime is proposed, although much refining is yet needed to make it fit for purpose.

- 9.2 The responsibility to provide any short form document to an investor should lie with the distributor. A coherent civil liability regime should support, rather than detract from, the desired focus on consumer friendly disclosure. Fundamental to this is ensuring that the requirements are structured in a way that product providers and distributors can be satisfied that they are capable of objectively demonstrating compliance with their obligations. Unless this prerequisite is met, many product providers and distributors may feel unable to manage their disclosure risk in relation to retail structured products. This is likely to result in some product providers and distributors exiting the market and reducing the range of products that are offered. This will result in a reduction in consumer choice and competition and an increase in the costs of products to consumers. It may also reduce the quality of products available.
- 9.3 The JAC members take the view that the following points should be considered when deciding what information should be included in a short-form disclosure document:
- Objective parameters to allow investment product providers to be confident that they have satisfied their obligations;
  - Clear scope of what is, and is not, considered "key information", including clarification as to whether product obligor disclosure is required and if so, to what extent;
  - If the investment product provider is to be liable for the short-form disclosure document, content requirements must be limited to information within the knowledge and control of the investment product provider;
  - Development of a glossary would be beneficial to both investors and the industry;

- Review and revision requirements must reflect the pre-contractual nature of the short-form disclosure document. Information which is potentially subject to constant change should be subject to periodic rather than continuous review;
- Length requirements should consider the space that will be required to provide high quality summary disclosure. Too short a document will result in over simplified disclosure which will reduce the utility of the document to investors. Requirements to be clear and concise are preferable to arbitrary length restrictions;
- A synthetic risk reward indicator should not be included on the basis it is likely to mislead investors and discourages investor engagement with the full risk profile of the product; and
- A non-prescriptive approach to presentation of past performance.

9.4 Whilst it may be helpful to have a short form disclosure document to compare different product wrappers offering the same economic exposure, we would urge IOSCO to acknowledge that different wrappers provide investors with choice and may be subject to different tax treatment, thereby making a meaningful comparison difficult. The overriding principle should be to ensure that any information included in the short form disclosure document is meaningful in the context of the product, even if this may be at the expense of absolute comparability across products.

**Issue 10 for consultation:**

**10.1 Do you agree that disclosure of disaggregated costs be made public or, alternatively, exchanged between the issuer and the distributor or the IOSCO member? Do you consider there to be an alternative mechanism to make disaggregated costs more transparent for retail investors? Do you think that the disclosure of such disaggregated costs would be useful to retail investors? Please explain.**

*Disclosure of disaggregated costs*

10.1 The JAC members fully support the view that 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.

If a structured product is packaged as an offer of a service for a fee and the fees charged for the provision of that service are generally absolute and not performance related, the investor needs to know the fees charged in order to work out what his investment return is likely to be. The issue for the investor is whether the price he is being charged for the return is cheap or expensive and he should be able to establish this by looking across the range of competing products and structures, if the fees for the service are disclosed. The JAC members agree that the ability to compare different products and to understand the costs and fees of the products is a very important element in the investment decision of an investor.

However, 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 being 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. Consequently, disclosure of profit margins or losses on hedging is irrelevant.

Reflecting the assumption of risk by the product provider, and the value add provided by the product provider, a retail structured product will typically include an embedded margin. This embedded margin on a retail structured product is not, therefore, the same as the profit to be made on a retail structured product because it is at risk, and may not be reached over the life of the product, being dependent on the characteristics of the product, hedging and its pricing model. In addition, the risk/reward to the investor is not affected by whether or not the product provider reaches, exceeds or falls short of the embedded margin (including where the provider ultimately suffers an economic loss on the product). The margin made (or lost) on a retail structured product is not comparable to, for example, an asset management fee for the product provider as such a fee is deducted from the net asset value of the product by way of fixed percentage cost and regardless of investment performance.

In relation to a defined return product (i.e. a product where the pay-off is described at the outset by reference to a specific asset, index or other value), an investor will receive at the pre-defined times (e.g. coupon payment dates, maturity) what the product documentation states the return will be. These are marketed as "hold to maturity" products. As an accommodation to the needs of consumers, there may be a secondary market in the product. The basis on which the secondary market is provided should be made clear to investors: prior to the maturity of the product, the price an investor may receive for their product on the secondary market may not be the price the investor paid for the product (or price payable at maturity). It is, therefore, essential to ensure that investors understand the secondary market (see paragraph 11.1 below).

The assumption of risk and accordingly reward for the product provider is intrinsic to the delivery of retail structured products and does not represent or give rise to consumer detriment provided that clear and broad disclosure is made as to the existence of the embedded product provider margin and its potential impact on secondary market pricing.

In addition, the overall price of a retail structured product should be a factor that is taken into account by distributors in their product selection and point of sale responsibilities when considering whether and how a product should be made available to their investor clients. It is important to delineate the responsibilities of a product provider and distributor when considering the appropriateness of the overall charge for a retail structured product.

Finally, JAC members take the view that detailed separation of components and disclosure of disaggregated costs on the level of each component would create an overload of information and jeopardise the point of the disclosure, to the point of being potentially misleading - not only for retail investors but also sophisticated investors and even regulators.

JAC members strongly believe that there should be no unbundling of component parts of the product requiring disclosure to the investor unless any such payment relating to the component part would constitute either (a) a commission (or equivalent) payable to the distributor to incentivise the sale of such product and/or (b) a fee payable by the investor.

### ***Alternative mechanism***

In light of the above, pricing transparency should rather be achieved with enhanced disclosure, in non-technical language, about what drives secondary market behaviours of these products (see below).

We are wholly in favour of an approach that has transparency at its heart. However, the JAC members are of the view that there are a number of significant obstacles which must be addressed before any specific pragmatic solutions can be formulated. The JAC members would be happy to consider this particular issue in further detail and would welcome the opportunity to comment on any alternative approaches.

**Issue 11 for consultation:**

**11.1 Do you think disclosing the estimated fair value of a structured product at the time of issuance will be helpful to investors? If so, why? If not, why not? What alternative information could be disclosed?**

*Estimated fair value*

11.1 The JAC members support, in principle, the concept of disclosure of an ‘estimated fair value’ or an ‘estimated fair value range’ for a retail structured product at the time of issuance as investors need to understand the difference between the original issue price of a structured note and its value in the secondary market as estimated by the product provider (The JAC members note that there is no secondary market for many products). The JAC would welcome the opportunity to work with IOSCO to develop this concept further in order to provide a meaningful and workable assessment of fair value for retail investors. The relevant product provider’s valuation should be a guide only as to the secondary market value of the product at the time of issuance only and should not be prescriptive in form. In order to ensure the valuation is not misleading, it should be made clear to investors that ‘fair value’ is not fixed and any estimate would only represent an assessment at that moment in time, whereas market movements could be significant over the holding period.

As discussed under Issue 10, generally retail structured products are ‘buy to hold’ investments. However, it may be helpful for investors to 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.

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.

**Issue 12 for consultation:**

**12.1 Do you think it appropriate that IOSCO members prescribe disclosure of scenarios? If so, what should these scenarios be? Do you consider there to be an alternative/simpler method of disclosing scenarios to retail investors? Please explain.**

*Scenarios*

12.1 The JAC members are generally supportive of the use of different scenarios, along with appropriate warnings regarding the limitations of the data used and warnings that the scenarios are not equally probable. Scenarios should provide an analysis of likely product performance in a wide range of normal and extreme market actions. However, the JAC members do not support the view that there should be prescribed disclosure of scenarios.

The JAC members are of the view that allowing the producer the flexibility to present scenario analyses in a variety of formats would assist accessibility (e.g. numerically, graphically and/or in a chart format). Product producers are often used to preparing marketing materials for products of this nature on a regular basis and are, therefore, familiar with what presentational approaches are generally best suited to particular product types and are expected and valued by distributors and end investors.

The JAC members take the view that a degree of flexibility with regards the approach taken for the preparation of scenario analyses would improve the utility of the data prepared. However, prescribing rigid calculation methodologies may risk generating inappropriate results for certain products. Some products will only require limited scenario analysis as there are only a few different potential outcomes so there should not be a requirement to provide a fixed number of scenarios in all cases.

A general requirement that the scenario analyses provided are prepared and presented in a manner which is fair, clear and not misleading should ensure appropriate standards are maintained.

**Issue 13 for consultation:**

**13.1 Do you think that disclosure of backtesting is useful to investors? What are the risks associated with such disclosure? Is there any other way to use backtesting to help retail investors?**

***Backtesting***

13.1 Backtesting is used to demonstrate how a product would have performed based on historical data sets. Caution should be exercised in the use of backtesting as it may not necessarily reflect actual performance or take into account all the variables that can affect the product, and as such, the outcomes may not provide a meaningful comparison to investors.

The JAC members do not regard the disclosure of backtesting as useful to investors and are of the opinion that it may even be misleading as positive backtesting results may lead investors to assume that past performance is an accurate indicator for future performance. The disclosure of historical data of the underlying however, may be appropriate and helpful for investors.

**Issue 14 for consultation:**

**14.1 What education tools could IOSCO members use when educating retail investors on retail structured products?**

**14.2 What guidance could IOSCO provide to its members to facilitate better investor understanding of retail structured products?**

***Education and guidance***

14.1 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. IOSCO members could provide access to training in structured products, including both the benefits and risks of the products, educational materials on structured products generally, in a suitable form (including written materials, market wide training, desktop training, or other forms, as appropriate) could be provided. The JAC members are of the view that the

provision of appropriate educational tools should form part of the obligations of distributors but any materials provided by IOSCO members to ensure consistency across the industry would be helpful.

- 14.2 The JAC members fully support the proposal that education measures should be put in place to assist investors to understand issues and risks relating to the particular type of retail structured products and suggested approaches should be provided that may assist investors in making investment decisions.

Investor education tools such as investor guides and interactive online materials, coupled with obligations of distributors under the suitability principles regarding products that they sell, can provide further information to investors regarding the benefits and risks of particular types of retail structured products.

We believe other investor education tools, including such as a standardised glossary may be useful to investors in this regard. This is discussed in more detail under Issue 8.

**Issue 15 for consultation:**

- 15.1 Do you think it appropriate for IOSCO members to require or encourage issuers to take some form of responsibility for the actions of the distributors that distribute their products? What impediments might IOSCO members face in implementing these types of requirements? Would the requirements have an effect on distributor behaviour?**

*Allocation of responsibility*

- 15.1 The question of the allocation of responsibility between product providers and distributors is complex – and cannot rest on the labels for the roles provided by each. It is, therefore, essential to consider the role of each of the product provider and distributor in relation to the distribution of a product and apply the responsibilities to the right role in the distribution chain. This will ensure that the person best placed to meet the applicable requirements is responsible for them. The JAC members do not support an approach where product providers are required to take responsibility for the actions of the distributors that distribute their products.

The JAC members believe that it is vital that product providers carry out a rigorous Know Your Distributor (KYD) process and ensure there is sufficient due diligence on the part of the distribution chain which they interact with and an understanding of the specific product distribution plan more generally. Ensuring that the channels of distribution are robust would mitigate the risk of targeting investors for whom a product is not suitable. KYD due diligence should include assessments of whether distributors are appropriate distributors for placing particular product types.

Distributors must understand the products they distribute. In jurisdictions where distributors provide not only the provider'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.

**Issue 16 for consultation:**

- 16.1 What other areas of activity could IOSCO members consider in the post sales**

period? Please explain.

**16.2 Are there issuers, that are not distributors, that make a secondary market in retail structured products (i.e., would the regulatory tool on secondary market making ever be relevant)?**

*Nature and level of post-sales information*

16.1 The JAC members agree that product providers should take some post-sales responsibility in relation to products that have been targeted at retail customers, including responding to any requests for information from distributors and ensuring that ongoing disclosure is available (The JAC members note that the Transparency Directive already regulates in this area across EU jurisdictions). However, since retail structured products are generally intended to be held to maturity, the level of post-sales information may be required to be tailored according to the nature and sophistication of the customer. As with other aspects of interface with the retail investor, this requires knowledge as to the investor's understanding, which the distributor is in the best position to assess. It is important to recognise that for some types of products a continuing legal relationship between the product provider and the ultimate customer is an essential feature of the product (e.g. deposits, funds and life policies), whereas for others (e.g. securities) the nature of the distribution chain may be such that the product provider may neither know nor be able to find out the identity of the ultimate client. All of these situations should be catered for in addressing post-sales disclosure issues.

*Alteration of terms*

Ongoing active management of a product post-sale may not be possible or desirable under the terms of an investment (e.g. where a structured note is held through a clearing system and/or investor consent is required to change the terms of a product). We believe that ongoing disclosure obligations place onerous responsibilities on product providers in relation to consumers (which would be more appropriate to apply to distributors). Although it appears that certain disclosures should be made by product providers to distributors (as the product provider will have the most information in relation to a product), this should not extend to requiring a product provider to contact investors directly. In addition, care would have to be taken in relation to ongoing disclosures that are made as they could give rise to reactions from consumers and distributors which may not be in their best interests (e.g. incurring penalties for early redemption). We would envisage that ongoing disclosures would also increase costs for a client due to the risk involved for a product provider in determining what should be disclosed and the level of disclosure.

## PARTICIPATING ASSOCIATIONS



Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 members, institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's website: [www.isda.org](http://www.isda.org).

ISDA is listed on the EU Register of Interest Representatives, registration number: 46643241096-93.



ICMA represents financial institutions active in the international capital market worldwide. ICMA's members are located in 47 countries, including all the world's main financial centres. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years, providing the framework of rules governing market practice which facilitate the orderly functioning of the market. ICMA actively promotes the efficiency and cost effectiveness of the capital markets by bringing together market participants including regulatory authorities and governments. See: [www.icmagroup.org](http://www.icmagroup.org)

ICMA is listed on the EU Register of Interest Representatives, registration number 0223480577-59.



AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan- EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1st November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association.

AFME provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European, and UK capital markets. AFME is the European regional member of the Global Financial Markets Association (GFMA) and is an affiliate of the US Securities Industry

and Financial Markets Association (SIFMA) and the Asian Securities Industry and Financial Markets Association (ASIFMA). For more information, visit the AFME website, [www.AFME.eu](http://www.AFME.eu).

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76



The voice of banking  
& financial services

The British Bankers' Association (BBA) is the leading trade association for the UK banking and financial services sector. We represent over 200 banking members, which are headquartered in 50 countries and have operations in 180 countries worldwide. These member banks collectively provide the full range of banking and financial services and make up the world's largest international banking centre.



The Institute of International Finance, Inc. (IIF), is the world's only global association of financial institutions. Created in 1983 in response to the international debt crisis, the IIF has evolved to meet the changing needs of the financial community. Members include most of the world's largest commercial banks and investment banks, as well as a growing number of insurance companies and investment management firms. Among the Institute's Associate members are multinational corporations, trading companies, export credit agencies, and multilateral agencies. Approximately half of the Institute's members are European-based financial institutions, and representation from the leading financial institutions in emerging market countries is also increasing steadily. Today the Institute has more than 400 members headquartered in more than 70 countries.



The Structured Products Association (U.S.) is the trade association for the American structured investments industry. Comprised of nearly 12,000 professionals, the SPA advocates for the structured products investment class among regulators, media, advisors and investors. The SPA promotes investor education as a core mission of the industry.

## [ANNEX 1

### PRINCIPLES FOR MANAGING THE PROVIDER-DISTRIBUTOR RELATIONSHIP (Published in July 2007)

#### A. Introduction

These PD 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 PD 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 PD 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 PD 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. Furthermore, the associations issued the PD 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 PD 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 PD Principles do not, unless otherwise indicated, address the role of entities acting solely as issuer of a product.

The PD 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 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 PD Principles, as appropriate, to take account of such specific factors.

## **B. PD Principles**

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

### PRINCIPLES FOR MANAGING THE DISTRIBUTOR-INDIVIDUAL INVESTOR RELATIONSHIP

(Published in July 2008)

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 DI Principles in mind in their dealings with individual investors in structured products. These DI Principles complement and should be read in conjunction with the "Principles for Managing the Provider-Distributor Relationship" (or PD Principles) set out in Annex 1 hereto, which focus on the relationship between manufacturers and distributors. These principles apply to the relationship between the distributor and the individual investor.

Although these DI 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 PD Principles noted above (PD 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 DI 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 DI 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.

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.

## **DI Principles**

These DI 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 DI Principles. Moreover, the DI Principles are to be taken collectively, rather than viewing any one DI Principle in isolation from the others.

### **15.2 Product Transparency**

The party who is primarily responsible for the creation of marketing materials, or is responsible for a prospectus, or other offering memorandum, should, to the extent permitted by applicable laws and regulations, 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' 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.

### **15.3 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 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.

### **15.4 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.

#### 15.5 **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.

#### 15.6 **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 they affect 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.

#### 15.7 **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.

#### 15.8 **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 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.

15.9 **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.

15.10 **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.

15.11 **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.

15.12 **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.

15.13 **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, and other pertinent information.]