

# **Regulation of Retail Structured Products**

## **Consultation Report**



**IOICU-IOSCO**

**THE BOARD  
OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

**CR05/13**

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## Foreword

The Board of the International Organization of Securities Commissions (**IOSCO**) has published for public comment this consultation report on the *Regulation of Retail Structured Products* (**Consultation Report**). The Consultation Report provides background on the project and the work undertaken by the Working Group on Retail Structured Products (**Working Group**) of the Task Force on Unregulated Markets and Products (**TFUMP**). It also proposes a regulatory toolkit (**Toolkit**) setting out regulatory options that IOSCO members may find useful in their regulation of retail structured products. *No regulatory action is proposed to be mandated by the Toolkit and it is recognized that not every Toolkit suggestion would work within the regulatory regimes of all IOSCO members. Use of any specific regulatory tool would be at the discretion and subject to the legal framework of the jurisdiction of each individual IOSCO member.* A final report will be prepared after consideration of comments received from the public in response to this Consultation Report.

## How to Submit Comments

Comments may be submitted by one of the three following methods **on or before Thursday 13 June 2013** help us process and review your comments more efficiently, please use only one method.

**Important:** All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

### 1. Email

- Send comments to [RetailStructuredProducts@iosco.org](mailto:RetailStructuredProducts@iosco.org).
- The subject line of your message must indicate *Regulation of Retail Structured Products*.
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc) to create the attachment.
- Do not submit attachments as HTML, PDF, GIFG, TIFF, PIF, ZIP or EXE files.

### 2. Facsimile Transmission

Send your comment letter by facsimile transmission using the following fax number: + 34 (91) 555 93 68.

### 3. Paper

Send three copies of your comment letter to:

**Mr. Tim Pinkowski**

General Secretariat

International Organization of Securities Commissions (IOSCO)

Calle Oquendo 12

28006 Madrid Spain

Your comment letter should indicate prominently that it is a '*Comment on Regulation of Retail Structured Products*'.

## Contents

Chapter	Page
<b>I</b> <b>Executive Summary</b>	<b>1</b>
<b>II</b> <b>Background</b>	<b>3</b>
<b>III</b> <b>Methodology</b>	<b>9</b>
<b>IV</b> <b>Summary of Survey Results</b>	<b>11</b>
<b>V</b> <b>Observations from Round Table Attendees</b>	<b>32</b>
<b>VI</b> <b>Regulatory Toolkit</b>	<b>35</b>

*This Consultation Report has been prepared by a working group of TFUMP. TFUMP is a multilateral group of staff experts from various IOSCO member jurisdictions. The proposed regulatory tools, analysis and conclusions in this Consultation Report do not necessarily reflect the views of any one IOSCO member.*

## I Executive Summary

At the meeting of the Technical Committee of IOSCO in Tokyo in February 2012, TFUMP was given approval to conduct work on retail structured products to:

- (a) Understand and analyse trends and developments in the retail structured product market, and related regulatory issues encountered by, and responses from, IOSCO members; and
- (b) Develop guidance, if appropriate, on regulatory responses.

IOSCO decided to conduct this work due to the growing concern among IOSCO members about the regulatory challenges posed by retail structured products.

To complete this mandate, the Working Group was formed.<sup>1</sup> The Working Group issued a survey to IOSCO members in mid-2012 (**Survey**) asking IOSCO members to outline:

- The retail structured product market in their jurisdiction;
- The regulatory regime for retail structured products; and
- The regulatory challenges observed within the markets for which they are responsible.

IOSCO members were also asked to offer their views on ‘best-practice’ regulatory approaches for dealing with the challenges observed in the market.

In early November 2012, the Working Group held a round table in London with representatives of banks involved in issuing retail structured products, law firms that advise firms active in the retail structured product market, derivative industry associations and consumer groups (**Round Table**). The purpose of the Round Table was to gather information from the attendees in order to help advance the Working Group’s understanding of the retail structured product market and the impact of possible regulatory responses on the market.

The Working Group used the results of the Survey and the feedback from the Round Table attendees to prepare this Consultation Report. This Consultation Report’s scope is governed

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<sup>1</sup> The members of the Working Group are the Australian Securities and Investments Commission (co-chair), the French Autorite des marches financiers (co-chair), the Federal Financial Supervisory Authority (Germany), the China Securities Regulatory Commission, the Comissão do Mercado de Valores Mobiliários (Portugal), the Comisión Nacional Bancaria y de Valores (Mexico), the Comisión Nacional del Mercado de Valores (Spain), the Commissione Nazionale per le Società e la Borsa (Italy), the Financial Services Agency (Japan), the Financial Services Authority (UK), the Financial Services and Markets Authority (Belgium), the Financial Services Board (South Africa), the Swiss Financial Markets Supervisory Authority, The Netherlands Authority for the Financial Markets, the Québec Autorite des marches financiers, Securities and Exchange Board of India, Securities and Futures Commission (Hong Kong) and the Securities and Exchange Commission (USA).

by the Working Group's mandate to include the *value-chain* of the retail structured product market, from issuance to distribution<sup>2</sup> to investment.

This Consultation Report:

- Provides background to the project;
- Describes the work undertaken by the Working Group;
- Analyses market trends and developments, and related regulatory challenges encountered by, and regulatory responses from, IOSCO members; and
- Consults on a proposed regulatory Toolkit that IOSCO members could use in their regulation of retail structured products.
  - The Toolkit has been developed with the goal of enhancing investor protection by providing regulators with possible approaches that may help address certain concerns with retail structured products.
  - The proposed tools are intended to allow for a wide range of application and adaptation in different jurisdictions, and regulators may choose to implement some, all, or none of them in their jurisdiction.
  - Regulators may conclude that the relevance of specific tools in their jurisdictions may vary according to the characteristics of their specific regulatory framework, the characteristics of the issuing entity, the characteristics of the product involved, or other factors. Regulators may therefore wish to incorporate these tools on a selective basis or in a manner best suited to their circumstances and national legal frameworks.
  - *No regulatory action is proposed to be mandated by the Toolkit and it is recognized that not every Toolkit suggestion would work within the regulatory regimes of all IOSCO members. Use of any specific regulatory tool would be at the discretion and subject to the legal framework of the jurisdiction of each individual IOSCO member.*

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<sup>2</sup> The Working Group notes that IOSCO addressed issues with respect to distributors (also known as intermediaries) in its FR01/13 *Final Report on the Suitability Requirements with respect to the Distribution of Complex Financial Products (Suitability Requirements)* Report of the IOSCO Board, January 2013. This report is available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD400.pdf>.

As stated in the *IOSCO Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation* (Oct. 2011): 'Market intermediaries generally include those who are in the business of managing individual portfolios, executing orders and dealing in, or distributing, securities.' According to the methodology, a jurisdiction may also choose to regulate as a market intermediary an entity that simply provides advice regarding the value of securities or the advisability of investing in, purchasing or selling securities. However, for purposes of this Consultation Report, the term intermediary in the U.S. securities sector refers to registered swap dealers and broker-dealers, not investment advisers.

## II Background

### 1. Introduction

#### *Overview of structured products*

Structured products encompass a broad range of typically complex financial instruments. These instruments share the characteristic of having an embedded derivative that provides economic exposure to reference assets, indices or other economic values.

The use of embedded derivatives (together with other financial instruments, such as zero coupon bonds) allows structured products to offer retail investors a broad range of economic exposures. For example, structured products can offer long or short positions, capital-at-risk or 'protected' market exposure and access to a wide range of asset classes (including commodities, equities, currencies, credit and interest rates).

Examples of structured products include:

- Structured notes, where the return on a debt security, such as a medium term note, is linked through an embedded derivative to the performance of reference assets, indices or other economic values;
- Structured funds, where the return on a fund is based, through derivatives or other portfolio management techniques, on the performance of reference assets, indices or other economic values;<sup>3</sup> and
- Structured deposits, where the return on a bank deposit is similarly dependent on the performance of reference assets, indices or other economic values.

Structured products are typically sold over-the-counter, although they may be listed in the form of exchange-traded notes.

Key actors in the retail structured product market include issuers, who 'manufacture' the structured products for issuance, and intermediaries who sell the products to the end investors. As discussed in the Survey findings below, issuers typically issue structured products to generate profit but some respondents found that issuers may also issue the products to supplement their sources of funding. Intermediaries may offer the products (for profit) to service the perceived investment needs of their clients. There can be vertical integration between issuers and intermediaries (within corporate groups) but business models also exist where issuers and intermediaries are not related.

The market for structured products has been developing since the early 1980s, when purchasers of the products were predominantly institutional investors.<sup>4</sup> The market has

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<sup>3</sup> In some jurisdictions such as the EU, structured funds may include structured Undertakings for Collective Investment in Transferable Securities (UCITS).

<sup>4</sup> Scott Peng and Ravi Dattatreya, *The Structured Note Market* (Probus, 1995), 1.

developed since then, with it proliferating from the early 1990s.<sup>5</sup> The contemporary market for structured products is substantial, despite some moderation during the recent financial crisis. For example, in 2010 sales were US\$45 billion<sup>6</sup> in the United States, while Belgium had €85 billion outstanding.<sup>7</sup>

### *IOSCO member interest in retail structured products*

Together with this growth in the market for the structured products, there has been a concomitant growth in concern among certain IOSCO members in appropriately regulating the behavior of issuers and intermediaries within their respective markets when the structured products are sold to retail investors. Several events, including the 2008 default on products relating to the failed investment bank, Lehman Brothers Holding Inc., have exposed the problems that can potentially affect retail investors in structured products. These events have raised concerns with certain IOSCO members about investor protection, particularly around investor understanding of the products, design, disclosure, suitability, mis-selling and post-sale product controls.

Recent examples of regulatory and policy action concerning retail structured products across jurisdictions include:<sup>8</sup>

- **France:** on 15<sup>th</sup> October 2010, the Autorité des Marchés Financiers (**AMF**) issued a position on the marketing of complex financial products, reminding producers and distributors of their obligations and responsibilities regarding the primacy of client interest, client information, assessment of the suitability and appropriateness of the investment services to be provided, and of the mis-selling risk inherent to complex financial products;<sup>9</sup>

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<sup>5</sup> Satyajit Das, *Structured Products & Hybrid Securities* (Wiley, 2001), 983.

<sup>6</sup> Reported by the staff of the SEC in Staff Summary Report on Issues Identified in Examination of Certain Structured Securities Products Sold to Retail Investors. Available at: <http://www.sec.gov/news/studies/2011/ssp-study.pdf>

<sup>7</sup> Figure cited by the Financial Services and Market Authority (FSMA): [http://www.fsma.be/en/Doormat/Consultations/Cons/Article/press/div/2011-08-12\\_consult.aspx](http://www.fsma.be/en/Doormat/Consultations/Cons/Article/press/div/2011-08-12_consult.aspx)

<sup>8</sup> Staff in the Division of Corporation Finance at the U.S. Securities and Exchange Commission (**SEC**) issued a comment letter to certain issuers of structured notes in an effort to improve disclosures with respect to future structured note offerings. The comment letter is available at: <http://sec.gov/divisions/corpfina/guidance/structurednote0412.htm>. In addition, staff in the Office of Compliance Inspections and Examinations at the SEC issued a *Staff Summary Report on Issues Identified in Examinations of Certain Structured Securities Products Sold to Retail Investors* (above footnote 6). The report summarizes the results of that office's sweep examination of the retail structured securities products business of 11 broker-dealers, covering a cross-section of the industry. As noted in this report, the SEC, as a matter of policy, disclaims any responsibility for any publication or statement by any of its employees. The views expressed in the report are those of the staff of the Office of Compliance Inspections and Examinations and do not reflect the views of the Commission or of others at the SEC. Finally, in Regulatory Notice 12-03, FINRA, the self-regulatory organization for U.S. broker-dealers, issued guidance concerning the heightened supervision of complex products (including structured products) and in Regulatory Notice 12-55, FINRA issued guidance concerning its suitability rule which covers structured securities products.

<sup>9</sup> See AMF position: [http://www.amf-france.org/documents/general/9662\\_1.pdf](http://www.amf-france.org/documents/general/9662_1.pdf)

- **Belgium:** the Financial Services and Markets Authority's (**FSMA**) declared a voluntary moratorium on the distribution of particularly complex structured products and subsequent consultation on rules on the distribution of structured products to retail investors;<sup>10</sup>
- **Hong Kong:** the Securities and Futures Commission's (**SFC**) Code on Unlisted Structured Investment Products issued in June 2010 which, among other things, requires key fact statements to be included in the offering documents for structured products;<sup>11</sup>
- **European Union:** the European Commission's (**EC**) work on packaged retail investment products;<sup>12</sup>
- **Mexico:** the National Banking and Securities Commission issued new regulation for sales practices, including among others, certain obligations for profiling structured notes and other complex products for the purpose of know-your-product requirements;<sup>13</sup> and
- **Japan:** the Financial Services Agency took administrative action against intermediaries in response to inadequate explanation of structured products to retail investors.<sup>14</sup>

## 2. Preparing this Consultation Report

This Consultation Report has been prepared by the Working Group. The mandate of the Working Group is to conduct the following work on retail structured products:

- Understand and analyse trends and developments in the retail structured product market and related regulatory issues encountered by, and responses, from IOSCO members; and
- Develop guidance, if appropriate, on regulatory responses.

### *Scope of report*

IOSCO, through the Working Group, has been particularly interested in exploring the market for retail structured products to understand drivers for both supply-side (i.e., issuer and distributor) behaviour and demand-side (i.e., investor) behaviour. The Working Group, as governed by its mandate, has therefore looked along the *value-chain* of the retail structured product market, from issuance to distribution to investment. For the purposes of this Report,

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<sup>10</sup> See the following press release:  
[http://www.fsma.be/en/Doormat/Consultations/Cons/Article/press/div/2011-08-12\\_consult.aspx](http://www.fsma.be/en/Doormat/Consultations/Cons/Article/press/div/2011-08-12_consult.aspx)

<sup>11</sup> The code is available at:  
[http://www.sfc.hk/sfc/doc/EN/intermediaries/products/handBooks/Eng\\_SIP.pdf](http://www.sfc.hk/sfc/doc/EN/intermediaries/products/handBooks/Eng_SIP.pdf)

<sup>12</sup> Detail of this work is available at: [http://ec.europa.eu/internal\\_market/finances-retail/investment\\_products\\_en.htm](http://ec.europa.eu/internal_market/finances-retail/investment_products_en.htm)

<sup>13</sup> The regulation is available at: <http://www.cnbv.gob.mx/Bursatil/Normatividad/Paginas/Casas-de-Bolsa.aspx>

<sup>14</sup> Details of these actions are available at: <http://www.fsa.go.jp/en/news/2012/20121016-1.html>,  
<http://www.fsa.go.jp/en/news/2011/20111216-1.html>

we consider ‘issuance’ to encompass the issuance, origination or manufacture of retail structured products (‘issuer’, accordingly, has a similarly broad meaning).<sup>15</sup>

With respect to distribution, as noted above, IOSCO recently published a set of principles entitled *Suitability Requirements with respect to the Distribution of Complex Financial Products (Suitability Principles)*. The purpose of the Suitability Principles is ‘...to promote robust customer protection in connection with the distribution of complex financial products by intermediaries, including guidance on how the applicable suitability requirements should be implemented.’<sup>16</sup> The Suitability Principles define *complex financial products* broadly and inclusive of *structured investments*.<sup>17</sup>

The Suitability Principles cover the following areas:

- Classification of customers;
- The duty of the intermediary to act honestly, fairly and professionally and take reasonable steps to manage or mitigate conflicts of interest that arise in distribution irrespective of the customer classification;
- Disclosure requirements;
- Protection of customers for non-advisory services;
- Suitability protections for advisory services (including portfolio management);
- Compliance function and internal suitability policies and procedures;
- Incentives; and
- Enforcement.<sup>18</sup>

The Working Group recognises that the Suitability Principles would be the basis for addressing issues identified with respect to the distribution of retail structured products. We have referred to the Suitability Principles where appropriate in the regulatory tools. In some limited instances, we have offered discussion on a specific regulatory tool that could be employed by IOSCO members with respect to distributors, if they see fit. These tools are expressed to be employed in a manner consistent with the Suitability Principles.

The Working Group has been using the following approximate definition of structured products to guide its work:

*Structured products are compound financial instruments that have the characteristics of combining a base instrument (such as a note, fund, deposit or insurance contract)*

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<sup>15</sup> If a party is not involved in the actual issuance of the securities, then they would not be considered an ‘issuer’ for purposes of this Consultation Report.

<sup>16</sup> See *Suitability Requirements*, IOSCO, supra fn 2, p. 8.

<sup>17</sup> Ibid, 5.

<sup>18</sup> IOSCO, *Suitability Requirements*, above footnote 2.

*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.*

This definition excludes instruments such as stand-alone options, contracts for difference or futures because in those cases the derivative is not embedded in another financial instrument. The definition also does not capture asset-backed securities, including collateralized debt obligations or securitisation products, nor exchange-traded funds.<sup>19</sup>

The Joint Forum released a report in 2008 where it noted on the basis of a survey of eleven countries that:

*“...[i]n general, the term “retail customer” is not defined. Instead, anyone who is not an ‘institutional’ or ‘professional’ investor (e.g., meets certain minimum net worth levels or is a corporation or trust) is generally treated as a retail customer.”<sup>20</sup>*

For purposes of this Report, structured products will be considered ‘retail’ when sold to retail investors or customers.

Retail investors are generally identified or defined on a jurisdiction-by-jurisdiction basis.

#### *Summary of content of report and preparation process*

This Consultation Report sets out the results of the Survey that asked IOSCO members for details of the retail structured product market in their jurisdiction, their regulation of retail structured products, and the regulatory challenges that they have observed within the markets for which they are responsible. IOSCO members were also asked to offer their views on ‘best-practice’ regulatory approaches for dealing with the challenges observed in the market. As noted below, 26 IOSCO members provided a response to the Survey.

The Consultation Report builds on all of the results of the Survey by setting out a proposed regulatory Toolkit that IOSCO members could consider using in their regulation of retail structured products.

The Toolkit is structured as a series of regulatory options that IOSCO members might find useful to address issues that they may observe or wish to address within their own jurisdiction. None of the options are presented as mandatory or normative principles or standards that IOSCO members must or should implement within their jurisdictions. Further, the Consultation Report does not offer any conclusion on the effectiveness of any individual regulatory tool. Accordingly, this Consultation Report has been prepared on the basis that individual IOSCO members are best placed to determine the appropriate regulatory response within their jurisdictions, based on the characteristics of their specific regulatory frameworks,

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<sup>19</sup> While focused on retail structured products, IOSCO members may find some of the Toolkit items helpful when evaluating other products.

<sup>20</sup> Joint Forum *Customer Suitability in the Retail Sale of Financial Products and Services*, April 2008 p. 11.

such that the Toolkit simply gives IOSCO members options to consider when making that determination.

The Survey informed the content of the Toolkit in four ways. First, the results of the Survey identified a broad range of regulatory responses to retail structured products by the respondents. Second, the Survey identified some market dynamics that the Working Group saw as indicating the utility of specific regulatory tools. Third, the Survey highlighted some of the regulatory drivers that have prompted respondent jurisdictions to act. Fourth, the Survey respondents identified some points that they believe constitute best practices for regulation of retail structured products. In addition to the Survey results, the development of the Toolkit has benefited from the diverse experience of members of the Working Group in their regulation of retail structured products.

The preparation of the Toolkit has also benefited from the feedback gathered from attendees at the Round Table held in early November 2012 in London. Round Table attendees presented a variety of perspectives from across market actors (banks, law firms, industry associations and consumer groups) and regions (Europe, the United States and the Asia-Pacific region).<sup>21</sup>

These perspectives were sought to provide feedback to the Working Group regarding its then-current thinking on the Toolkit and the effectiveness and impact of regulation as observed on-the-ground by both supply- and buy-side participants. Attendees provided a number of valuable perspectives on market developments and the impact of regulatory tools on the market. This Consultation Report seeks to build on the Survey and the information gathered at the Round Table by soliciting an even-broader range of comments from stakeholders with an interest in the regulation of retail structured products.

The Working Group is conscious that retail structured products can be issued outside the securities sphere via banking or insurance products. IOSCO members may not have jurisdiction over such products. The Working Group's approach to this issue has been to recognise it and, via the Toolkit below, suggest that members are aware of the consequences of having regulation of retail structured products split across sectoral and regulatory lines.

The primary purpose of this Consultation Report is to seek input from interested parties on the Survey results and the Toolkit.

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<sup>21</sup> Eight attendees represented European organisations; two represented Asia-Pacific organisations; and one represented a United States organisation.

### **III Methodology**

As noted, the project so far has been largely based on an analysis of the Survey responses received from 26 jurisdictions.<sup>22</sup> These Survey results have been supplemented with feedback from the Round Table attendees and Working Group members.

The Survey questionnaire sought information about both the retail structured product market in respondent jurisdictions and regulatory experience with retail structured products. It included a number of other questions designed to gauge the structure and operation of markets to explain the significance of any differences in regulatory approach across jurisdictions and to build consensus on potential areas in which to develop possible regulatory responses. Where necessary and possible, respondent jurisdictions were asked to seek information from industry and other external parties to support their responses (although we note that not all respondents were able to consult with external parties).

Specifically, the Survey sought information on the following:

#### **1. Market details**

Information was sought on the legal scope and definition, if any, of retail investors and retail structured products as well as market size, market features, and supply and demand-side drivers.

The primary purpose of these questions was to better understand key factors driving the market, market trends and developments.

Questions were also intended to provide context around retail structured product markets in different jurisdictions to assist in comparing regulatory approaches around the world.

#### **2. Current regulatory framework**

These questions sought information on the existing regulatory approach relating to retail structured products in each jurisdiction. The aim of these questions was to allow the Working Group to easily compare the similarities and differences in the regulatory approaches between jurisdictions, and the types of regulatory tools that are used to address challenges identified in the market.

Namely, respondents were asked to detail (and describe if relevant) whether the following requirements or standards are present in their jurisdiction:

- Disclosure and marketing standards with specific indication on whether such standards are applicable to the issuer/product provider or the intermediary distributing the product;

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<sup>22</sup> List of respondents: Australia; Austria; Belgium; Brazil; Finland; France; Germany; Greece; Hong Kong; Hungary, Iceland; India; Italy; Japan; Lithuania; Maldives; Malta; Mexico; Portugal; Quebec; Slovenia; South Africa; Spain; Switzerland; The Netherlands and the United Kingdom.

- Suitability requirements imposed on issuers/product providers or distributors;
- Issuer/product provider regulation such as product approval processes, limits regarding the type and/or amount of products and constraints on product manufacturing;
- Market intermediary regulation as this applies to distribution and sales of retail structured products (including product approval processes, pricing, manufacturing constraints);
- Product intervention powers and criteria in the issuance, marketing, or sale of retail structured products (or similar powers, such as pre-approvals for marketing or disclosure);
- Collateral and margin requirements (if applicable); and
- Regulatory capital requirements if covered by the securities market regulator.

### **3. Regulatory drivers**

These questions sought information about the factors that have driven the development of respondents' existing regulatory approaches and the types of issues that have been highlighted as concerns in various jurisdictions, to gain further insight into how regulators around the world have responded to challenges posed by retail structured product markets.

Information was sought about:

- Objectives of the regulatory approach taken;
- Market phenomena (looking along the value chain from issuance to distribution to investment) which has driven the existing regulatory approach or proposed regulatory changes;
- The volume and type of investor complaints that the relevant agency has received in relation to retail structured products;
- Any unaddressed regulatory challenges; and
- Any challenges across jurisdictions.

In addition, views were sought for what could constitute the features of an international 'best practice' regulatory approach.

### **4. Regulatory effectiveness**

These questions sought information on whether respondent jurisdictions had conducted a review or analysis of the effectiveness of the regulatory framework in place (i.e., an *ex ante* cost benefit analysis or an informal or formal review of the framework itself or the enforcement regime). This information would assist the Working Group to gain insight on whether jurisdictions had assessed the effectiveness of the regulatory framework in place, and on the findings of that review or analysis (if applicable).

## IV Summary of Survey Results

This section summarises the Survey results.

### 1. Market details

- **Definitional challenges**

#### *Retail investor*

In the vast majority of respondent jurisdictions, there is no positive (legal) definition of ‘retail investor’.<sup>23</sup> Most jurisdictions have no definition at all, or define retail investors by opposition to, or exclusion of, professional investors.

#### *Structured product*

Only three respondent jurisdictions (Hong Kong, Lithuania and Mexico) had a legal definition of structured product (in the case of Mexico, it was of ‘structured note’).

In some other jurisdictions, the definition is either not a legal definition (Australia or Belgium), or only a few specific instruments are defined.<sup>24</sup>

- **Market size**

One of the concerns of the Working Group that has developed as its work has progressed is to enhance the level of data exchange between countries in order to make market data for retail structured products more complete and readily available.

While the Working Group sought quantitative data on the size of the retail structured product market in respondent jurisdictions for the year ending December 2011, this data suffered from differences between jurisdictions over the definition of ‘structured product’ and the fact that not all countries actively gather data on the retail structured product market. Accordingly, it was difficult to obtain and present data that was consistent and complete across jurisdictions. As such, no data is set out in this Report.

- **Market features**

#### *Issuers*

Twenty respondent jurisdictions identified financial institutions (such as banks, or other financial entities) as the key manufacturers or issuers of retail structured products in their jurisdiction.<sup>25</sup> Other key issuers include:

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<sup>23</sup> With the exception of Mexico and Brazil.

<sup>24</sup> For example, the UK for structured capital-at-risk products and structured deposits; Italy for structured bonds; and structured UCITS in the EU regime.

<sup>25</sup> For example in Australia, Belgium, Brazil, Finland, France, Germany, Hong Kong, Malta, Quebec, Slovenia, South Africa, The Netherlands, Portugal and the United Kingdom. Financial institutions,

- Mutual funds (Greece);
- Non-banking financial companies (India);
- Large fund managers (Australia, Hungary, Quebec);
- Insurance companies (Slovenia, South Africa, Portugal and Quebec);
- Boutique fund managers (South Africa, Malta, Australia);
- Securities dealers (Switzerland and Hong Kong);
- International investment houses (Hong Kong); and
- Brokerage houses (Mexico).

#### *Distributors*

Sixteen respondents identified distributors as being either the issuer, or an entity affiliated with the issuer.

- *The Netherlands, Quebec, Portugal, Lithuania*: identified that structured products are typically sold directly to investors;
- *Italy, Belgium*: noted that structured products are typically manufactured by banks and distributed through the branches or intermediaries of the same banking group;
- *Germany, Canada, Brazil, Hungary (for structured deposits)*: said that sales are typically advised in bank branches;
- *Spain, Lithuania, Malta, Greece, India*: identified private wealth management firms as the most salient distribution channel in their jurisdictions, with a presence of these types of firms also in Switzerland, Australia and South Africa;
- *India*: noted that products are mainly sold through distributors, which may not be the issuer itself or its subsidiary;
- *UK, Australia*: Financial advisors (who may or may not be affiliated with the issuer) were noted as the dominant distributors;
- *Slovenia*: Insurance companies were identified as dominant distributor, where products are typically distributed to retail investors through agents;
- *Hong Kong*: identified that distribution could come from banks, brokers or advisers, however direct marketing to retail investors is rarely seen from non-banking financial distributors.

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including bank holding companies and investment banks, are the primary issuers of structured notes in the United States.

### *Key features of retail structured products*

Twelve respondents identified capital protection as a key feature of retail structured products in their jurisdiction.<sup>26</sup> These jurisdictions include: Brazil (nearly 100 per cent of the market), Belgium (around 70 per cent), India (about 85 per cent), Germany (69 per cent fully protected, 31 per cent partly protected), Finland (around two-thirds of the market), Portugal (around 53 per cent), Lithuania (particularly non-advised customers), the UK, Spain, Hungary and Mexico.

Only Hong Kong identified a strong prevalence of non-capital protected products. Australia noted a shift away from capital protected products because of lower demand and increases in the costs of protected financial instruments for issuers.

In relation to other features, products linked to equities, including baskets or indices, were identified as popular in Portugal, Belgium, the UK, Australia, India and Italy. The UK and Portugal identified a recent increase in products linked to multiple underlying assets, including multiple indices. Products linked to interest rates were identified as common in Belgium, the UK, Spain, and Italy. Currency linked products were identified as popular in Hong Kong, Mexico and the UK.

Belgium, Australia and Hungary identified medium to long term maturity dates for retail structured products, with Hungary identifying products with maturity dates of less than one year as being popular. India identified products generally having maturity dates of one to three and a half years. Australia noted a shift towards more defensive asset classes, such as gold and defensive currencies, and features that enable investors to walk away from products without incurring a break cost.

### *Demographics of investors*

Three respondents provided demographic characteristics of particular investors in their jurisdiction:

- *UK:* investors in structured deposits are more likely to: be over 55 or under 35 years of age; have a higher household income; and have three or more different types of savings products;
- *Hong Kong:* the typical listed structured product investor was young (42 years old), with a monthly personal income (USD2,900) and a monthly household income (USD7,100). They comprised a larger proportion of younger individuals, individuals employed in the finance industry, and individuals of higher work status than investors in equities or ETFs;
- *Australia:* investors in capital protected products are more likely to be older, have a higher income and be influenced from a financial advisor relative to investors of other financial products.

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<sup>26</sup> Capital protection is a feature of structured products that are structured so that an investor's initial investment (at least) is returned to the investor at the maturity of the product regardless of the performance of reference assets, indices or other economic values. The structured product, however, remains subject to the credit risk of the issuer so that the protection is subject to the ability of the issuer to meet its obligations.

- **Supply-side drivers**

The most common supply-side drivers include profit and access to an alternative funding source. Other supply-side drivers identified were: hedging, the needs or input of other parties, the need for issuers to remain competitive in the market, and regulatory restrictions on other products.

*Profit*

Twenty respondents noted profit as a supply-side driver, with four jurisdictions<sup>27</sup> naming profit as the most important driver. This is primarily due to the fee structure and margin (e.g., through pricing, or with fair value lower than nominal value) attached to products.

*Access to a funding source*

Seventeen respondents<sup>28</sup> identified access to an alternative funding source as a supply-side driver. This is particularly relevant in a low interest rate environment and where there is pressure on other funding sources (e.g., interbank funding). Most of the time, this driver is based on diversification of funding. Some respondents noted that only specific structured products can play a funding role (i.e., long term products with no leverage). India noted that structured products are issued in a high interest rate environment, as it is easier for issuers to protect the principal asset.

*Hedging*

Views were mixed regarding the role of hedging with only eleven respondents<sup>29</sup> noting hedging (i.e., the issuance of products to lay off an existing financial exposure) as a supply-side driver.

*Other parties*

Ten respondents<sup>30</sup> recognized the role of other parties (mostly professional investors, distributors and/or advisors) and white-labelling (i.e., arrangements where a product or service is offered under the brand of the distributor while a separate company actually makes the product or provides the service) in driving the issuance of retail structured products.

- **Demand-side drivers**

The most common demand-side drivers (i.e., reasons for investors to purchase retail structured products) include asset class access/portfolio diversification, yield, and the availability of advice.

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<sup>27</sup> Finland, Hungary, Spain and The Netherlands.

<sup>28</sup> Australia, Belgium, Finland, France, Germany, Hong Kong, Hungary, India, Italy, Lithuania, Mexico, Portugal, Quebec, South Africa, Spain, The Netherlands and the United Kingdom.

<sup>29</sup> Belgium, France, Hong Kong, India, Italy, Malta, Mexico, Quebec, Spain, Switzerland and the United Kingdom.

<sup>30</sup> Australia, Belgium, France, Germany, Hungary, India, South Africa, Spain, Switzerland and the United Kingdom.

### *Asset class access/portfolio diversification*

Twenty-one respondents<sup>31</sup> confirmed that portfolio diversification (especially market exposure together with capital protection) and access to specific market exposure or asset class (such as commodities, gold, house prices, foreign currencies, infrastructure, average return of multiple assets, etc.) are demand-side drivers.

### *Yield*

Twenty respondents<sup>32</sup> noted that yield is an important demand driver (with Australia noting that yield can be even more important for investors than the search for capital gains). Yield enhancement often goes with higher risks (like market and credit risk), a consequence not always understood by retail investors and therefore an attention item for regulators. Some respondents stressed the yield enhancement feature of structured products is often put forward as a sales argument rather than as a demand driver.

### *Leverage*

Opinions were diverse on whether leverage is a key demand-side factor. For example, in Germany and the Netherlands leveraged products are frequently sold whereas, in the United Kingdom, leveraged structured products are not common in the mass retail market.

### *Capital protection*

Most respondents<sup>33</sup> consider that capital protection is a strong driver for risk-averse retail investors to invest in retail structured products. Three respondents, however, explicitly do **not** consider capital protection as a significant demand-side driver.<sup>34</sup>

### *Tax*

The majority of respondents<sup>35</sup> considered tax **not** to be a demand-side driver. However, in countries where particular tax regimes are in place, the opposite is true (in Italy, France, Switzerland, Australia, the United Kingdom for certain investment wrappers, and Belgium and Slovenia with respect to life insurance products).

### *Advice*

In most responding countries,<sup>36</sup> investors purchasing retail structured products rely strongly on advice (for example in Hungary, Mexico, Finland, Australia, and Germany) and thus the intermediary channel is important.

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<sup>31</sup> With the exception of Austria, Greece, Iceland, Japan and Maldives.

<sup>32</sup> With the exception of Austria, Greece, Iceland, Japan, Maldives and Mexico.

<sup>33</sup> With the exception of Austria, Iceland, France, Greece, Japan, Lithuania, Maldives, Mexico, Portugal, Slovenia and Hong Kong.

<sup>34</sup> Portugal, Lithuania and Slovenia.

<sup>35</sup> With the exception of Australia, Belgium, France, Italy, Portugal, Quebec, Slovenia and Switzerland.

<sup>36</sup> With the exception of Brazil, France, Japan, Iceland, Maldives, Slovenia and Spain.

## *Advertising*

Advertising is a driver for investor demand in approximately half of the responding jurisdictions.<sup>37</sup> For those who consider advertising to be important, aggressive marketing (notably France) and imbalanced presentations of product features (Portugal) is noted. Australia cited investor education as an aim of advertising campaigns. Belgium, Mexico, Italy, The Netherlands and the United Kingdom have issued guidelines for advertising.

## **2. Current regulatory approach**

- **Existing securities regulation approach for retail structured products**

### *Disclosure and marketing regulatory standards*

Twenty-four respondents<sup>38</sup> reported having disclosure and marketing regulatory standards.

Disclosure standards are common. The high level principle for the prospectus or offering documents is that information provided to investors must be presented in a clear, concise, understandable manner and not in a misleading or deceptive way. In particular, investment firms are obliged to provide the client with all the relevant information to allow him/her to make an informed investment decision. Responding jurisdictions indicated that there should be appropriate guidance to investors on the nature and risks associated with investments.

Marketing communications are commonly required to be not false or misleading, and they must not simply advertise certain positive aspects without pointing out the relevant negative aspects as well.

There are differing regulatory approaches regarding the pre-approval of the advertising material by the competent authorities. For example, in:

- *Portugal, Belgium,*<sup>39</sup> *France:* it is compulsory to submit marketing communications prior to distribution to the public to check the compliance with certain rules and good practices;
- *Hong Kong:* before an unlisted structured product can be offered to the public, the product and the offering documents must have the SFC's prior authorization having regard to requirements under a Code,<sup>40</sup> unless an exemption applies;
- *Italy:* there is no pre-approval of advertisements but CONSOB has the power to prohibit or suspend advertisements;

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<sup>37</sup> Australia, Belgium, Finland, France, Germany, Greece, Hungary, Lithuania, Mexico, Portugal, Slovenia, Switzerland and the United Kingdom.

<sup>38</sup> With the exception of Iceland and Maldives.

<sup>39</sup> This requirement does not apply to structured products wrapped as an insurance product.

<sup>40</sup> Code on Unlisted Structured Investment Products available at:  
[http://www.sfc.hk/sfc/doc/EN/intermediaries/products/handBooks/Eng\\_SIP.pdf](http://www.sfc.hk/sfc/doc/EN/intermediaries/products/handBooks/Eng_SIP.pdf)

In other jurisdictions, such as The Netherlands and Quebec, there is no official pre-approval of advertisements. In the case of collective investment schemes, it is compulsory at the EU level for an *ex ante* notification to the competent authority of the prospectus and the key information document (**KID**) (for UCITS) by the issuer or management company of the UCITS. Germany has a requirement<sup>41</sup> similar to the KID, which demands an investment adviser to hand over a brief information document to the customer. This regulation applies to a range of financial products, including structured retail products. In India, issuers are required to make a detailed scenario analysis/valuation matrix showing the value of the security under different market conditions such as rising, stable and falling market conditions shall be disclosed in a table along with a suitable graphic representation.

In order to ensure adequate processes are put in place by intermediaries to prevent mis-selling of financial products which do not have an active secondary market or are particularly complex, CONSOB has guidelines on the distribution of illiquid financial products. The guidelines include recommendations on how to comply with the Markets in Financial Instruments Directive (**MiFID**) disclosure requirements in the distribution of illiquid financial products to retail clients.<sup>42</sup>

### *Suitability requirements*

Twenty-two respondents<sup>43</sup> noted that suitability assessments are required when firms provide financial advice.<sup>44</sup> In the EU, MiFID provisions supply the relevant standards. According to these rules, when providing investment advice or portfolio management, the investment firm must collect the necessary information from the client on their knowledge and experience, on their financial situation and their investment objectives so as to enable them to provide suitable investment services and products to the client. When providing non-advisory services, an appropriateness assessment is required, and investment firms have to ask the client about their knowledge and experience.

Most non-EU respondents require investment firms, when making a recommendation, to determine that the product is suitable for the clients' risk profile and needs. Further, they require firms to provide clients with adequate information to assist them in making an informed investment decision.

### *Issuer/product provider regulation*

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<sup>41</sup> Produktinformationsblatt (PIB), § 31- 3a WpHG

<sup>42</sup> Intermediaries are recommended to provide on an ex-ante basis information about: (i) costs on an unbundled basis, (ii) the disinvestment value of the product at a time immediately following the completion of the transactions; (iii) how the investor may disinvest the purchased product, highlighting any difficulties to disinvest, the resulting costs and the timeframe for disinvestment, (iv) a comparison of the risk/return of the illiquid financial product with simple, well known and low risk liquid products, which have analogous maturity as the illiquid product, and, if any, with substitutive products having a wide diffusion and adequate liquidity, and (v) performance scenarios based on objective simulation analyzes.

<sup>43</sup> With the exception of Iceland, Maldives, Slovenia and Switzerland.

<sup>44</sup> See footnote 2 concerning market intermediaries that provide advice.

Twenty jurisdictions<sup>45</sup> reported some form of issuer and/or product provider regulation.

At one level, some responding jurisdictions pointed out the obligation for providers to register and submit for regulatory review (or seek pre-approval of) prospectuses and, in some cases, marketing materials with or by the competent authority when a public offering is being carried out by the issuer.<sup>46</sup> Respondents indicated that this is more common in the case of collective investment schemes.

At another level, some responding jurisdictions have rules regarding product design and governance of new products. For example, in:

- *United Kingdom*: guidance has been issued to providers such that they should identify a target market and undertake stress-testing of the product to ensure they are capable of delivering good outcomes for customers. In addition, these standards state that product providers should have in place internal policies to ensure adequate staff, technology, financial resources, and proper internal tools to monitor and deal with risks;
- *Italy*: guidelines on the distribution of illiquid financial products have been established, recommending, *inter alia*, special care in the stage of product engineering, identification of target markets and internal processes to price such products;
- *Hong Kong*: the applicable codes and guidelines set out the eligibility requirements for the issuer, reference assets and collateral, amongst other things.

#### *Market intermediary regulation*

Twenty respondents<sup>47</sup> pointed to the existence of some kind of market intermediary regulation:

- *EU*: the relevant provisions are the MiFID rules on conduct of business and conflicts of interest. Some countries have also adopted specific individual suitability and organizational requirements for market intermediaries irrespective of the disclosure duties;
- *United Kingdom, France*: have regulations which seek to prevent the marketing of products by distributors without a thorough and clear understanding of the product, especially when providing investment advice;
- *Italy*: guidelines have been established to specify how MiFID provisions should apply to the distribution of illiquid financial products and how to improve comparability across products;

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<sup>45</sup> With the exception of Finland, Germany, Iceland, Maldives, Malta and Portugal.

<sup>46</sup> For example in Belgium, France, Portugal and Hong Kong there is an approval process for marketing materials and (in the case of Hong Kong) offering documents.

<sup>47</sup> With the exception of Iceland, Maldives, Malta, Mexico, Slovenia and Switzerland.

- *Spain, France*: conditions regarding target clients have been established;
- *Hong-Kong*: banks are obliged to provide a pre-investment cooling-off period of at least two calendar days to allow retail customers with less sophistication to think carefully about the proposed investment;
- *Germany*: a compliance officer must be incorporated into the new product approval process to ensure compliance with the code of conduct rules;
- *Belgium*: the Belgian FSMA has invited intermediaries active in the commercialization of structured products to retail investors not to commercialize particularly complex structured products (see below, product intervention powers and criteria).

### *Product intervention powers and criteria*

Twenty respondents<sup>48</sup> have product intervention powers of some kind. There are a wide variety of possible intervention powers and the type, timing or degree of intervention differs greatly among jurisdictions. A common reported measure (which tends more towards disclosure regulation) is the power to require the amendment or inclusion of warnings in the prospectus that issuers have to register with the competent authority when there is a public offer, and the pre-review or pre- approval of the marketing materials and advertisements.

Some respondents<sup>49</sup> – including those from EU jurisdictions – may prohibit or temporarily suspend the public offering of the product, the diffusion of an advertisement relating to a product, or the trading on a market of financial instruments.

In Austria, general regulations for insurance businesses allow the prohibition of the issuance of insurance products if the actuarial bases do not correspond to legal requirements.

As mentioned, in summer 2011 the Belgian FSMA called upon the financial sector not to distribute structured products to retail investors that are considered particularly complex. Distributors that sign on to the voluntary moratorium commit themselves not to distribute structured products that meet one of the features defined by the FSMA.<sup>50</sup> Nearly all representative actors involved in distributing structured products in Belgium, in both the banking and insurance sectors, have signed on to the moratorium.

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<sup>48</sup> With the exception of Iceland, India, Maldives, Malta, Switzerland and South Africa.

<sup>49</sup> For example in Australia, Germany, Italy and Hong Kong.

<sup>50</sup> There are four criteria:

1. The underlying value is not sufficiently accessible and observable for the retail investor (e.g., CDS and hedge funds are considered non-accessible and non-observable for retail investors);
2. The strategy of the product is overly complex (e.g., teaser products);
3. The calculation formula comprises more than three mechanisms; or
4. There is not enough transparency regarding all costs associated with the product, regarding the credit risk and regarding the market value of the product. For more detailed information [www.fsma.be/moratorium](http://www.fsma.be/moratorium)

According to Regulation 1095/2010 of 24 November 2010 establishing the European Securities and Markets Authority (**ESMA**), ESMA may under certain conditions temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the EU.

Additional powers for competent authorities on product intervention are envisaged in the EU under the current MiFID review.

#### *Collateral and margin requirements*

Only ten respondents<sup>51</sup> reported having collateral and margin requirements.<sup>52</sup> In most of these jurisdictions, these requirements have been set up to limit the counterparty risk for the use of both derivatives and other efficient portfolio management techniques (such as repurchase agreements and securities lending) by structured funds (UCITS in European jurisdictions).

#### *Regulatory capital requirements*

Fifteen respondents<sup>53</sup> reported requiring regulatory capital of some type (i.e., as it applies to distributors or issuers). Most of these jurisdictions refer to the obligation for investment firms to maintain adequate financial resources. For banks, these requirements are covered by the banking regulator due to its prudential duty. Irrespective of prudential capital requirements, France requires that the outcome of structured funds be guaranteed by an external formal guarantor in order to ensure that investors receive at redemption exactly what they have been offered.

- **Other regulatory approaches for retail structured products**

Generally, based on respondents' answers there were no other relevant regulatory frameworks applicable to retail structured products.

Some countries (Japan, Spain, Slovenia) reported similar or equivalent regulatory treatment for banking and insurance products.<sup>54</sup> In Italy, in order to limit regulatory and product arbitrage and enhance investor protection in relation to products more difficult to understand, the legislator extended the scope of application of prospectus related requirements to any offer of financial products to the public. Moreover, the same set of MiFID-like rules apply across the securities, banking and insurance sectors, including where financial insurance and banking products are distributed by banks and insurance undertakings. In Belgium, the voluntary moratorium on particularly complex structured products applies to all structured products irrespective of the wrapper.

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<sup>51</sup> Australia, Austria, Belgium, France, Germany, Greece, Hong Kong, Italy, South Africa and the United Kingdom.

<sup>52</sup> The responses mostly related to requirements that would apply issuers of retail structured products.

<sup>53</sup> Australia, Austria, Belgium, France, Germany, Greece, Hong Kong, Hungary, India, Italy, Japan, Malta, Mexico, Spain and the United Kingdom.

<sup>54</sup> In the U.S., certain retail structured products such as structured certificates of deposits and insurance annuities are subject to banking and insurance regulatory frameworks, respectively.

- **Proposed regulatory changes**

Sixteen respondents reported that at the time of the survey they were contemplating changes to the existing regulatory framework applicable to retail structured products.<sup>55</sup>

EU countries refer to the amendments envisaged for the MiFID and Insurance Mediation Directive (**IMD**)<sup>56</sup> to enhance investor protection as well as a proposal for a **KID** to retail investors relating to the proposals on packaged retail investment products (**PRIPs**). This new regulatory framework aims to treat substitutable retail banking, securities and insurance investments in a consistent manner in terms of disclosure and selling practices.<sup>57</sup>

According to the MiFID amendment proposal, structured deposits will fall within MiFID scope and structured UCITS will be excluded from the execution only regime. Internal processes at investment firms will be strengthened in connection with the definition, approval and oversight of policies, including stress testing, regarding products to be offered to prospective clients.

Aside from MiFID, other proposed individual regulatory changes included the following:

- *Portugal*: there were proposals for a sole regulatory instrument to apply to the information, advertising and marketing of all complex financial products;<sup>58</sup>
- *Belgium*: a public consultation has been carried out to develop a new regulatory framework for the distribution of structured products to retail investors;
- *Australia*: possible modifications to the regulatory regime are being considered and, as appropriate, implemented in several fields such as conflicted remuneration/duty to act in best interests of client, suitability, product naming and advertising, to address investor protection concerns;
- *India*: SEBI is working on developing new regulation of investment advisors across all the financial products;
- *United Kingdom*: the regulatory approach is being changed to do more to prevent investor detriment rather than focusing on finding redress for customers after detriment occurs. Work is underway in terms of improving product governance (in terms of product design and management over the product's full lifespan) and provider product governance standards. The United Kingdom also recognizes the potential need to introduce product intervention rules where necessary, in line with the powers envisaged in the new version of MiFID;

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<sup>55</sup> For example changes are being contemplated in Australia, Brazil, Mexico and South Africa. Belgium, Lithuania, Portugal, and the UK are also contemplating changes in parallel with EU initiatives.

<sup>56</sup> In particular, the EU Commission has proposed to introduce new requirements under the IMD on suitability, appropriateness and reporting to clients when insurance intermediaries or undertakings advise, sell or offer insurance investment products to retail customers.

<sup>57</sup> See footnote 7.

<sup>58</sup> We note that this proposal has been finalized since the responses were received.

- *Lithuania*: there are considerations for the introduction of a duty on developers and sellers of structured products to provide the regulator with certain essential product information prior to distribution;
- *Mexico*: a prohibition on payments from the sponsoring financial institutions to the distributors of the securities listed in the SIC will soon be introduced; and
- *Brazil*: there has been the recent introduction of regulatory changes to retail structured products, notably to funds, to strengthen disclosure requirements. Amendments to the regulatory framework of portfolio management and suitability requirements are also underway.

### 3. Regulatory drivers

- **Key objectives of regulatory framework**

Twenty respondents<sup>59</sup> reported that one of the key objectives of their regulatory frameworks is the protection of investors.

Ten respondents also identified the mitigation of systemic risk and/or stability of financial system as another key objective. Other key objectives noted by respondents include ensuring transparency, prevention of misconduct by intermediaries and enhancing market integrity.

Most respondents do not have a tailored regulatory framework focusing on retail structured products.

- **Regulatory drivers**

Respondents identified a variety of market phenomena that have driven their existing regulatory frameworks or proposed regulatory changes.

Overall, a number of respondents raised concerns over observed market failure, suitable or optimal investment choice, misleading and deceptive conduct, high levels of customer complaints and concerns about the complexity of retail structured products as regulatory drivers.

Specific examples include the following:

- *Collapse of Lehman Brothers*: several respondent jurisdictions identified the collapse of Lehman Brothers as a market phenomenon that had driven regulatory action, particularly Hong Kong and the United Kingdom. For example, the collapse had a significant impact on UK retail investors with structured products and Switzerland also raised the impact of the failure of Lehman Brothers as a concern. Italy and Germany identified that Lehman's collapse caused a number of complaints, due to alleged mis-selling of these products to retail investors. Belgium stated that Lehman's collapse highlighted the credit risk with which investors were faced.

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<sup>59</sup> With the exception of Hungary, Maldives, Malta, Spain and The Netherlands.

- The United Kingdom’s investigation following Lehman’s collapse found failings with the advice given to retail investors as well as deficiencies in marketing material. More specifically, there was:
  - poor identification of the target market;
  - lack of due diligence on counterparties;
  - inadequate testing of product features;
  - lack of due diligence on distribution channels; and
  - poor use of customer feedback and other management information.
- *Information asymmetry/disclosure (market failure)*: seven responding jurisdictions<sup>60</sup> raised concerns about information asymmetries (i.e., where the issuer/distributor holds more information than the investor) or deficiencies in disclosure material. For example, Finland and Mexico raised concerns about the disclosure of fees while Quebec and Belgium raised concerns about disclosure of return possibilities, costs and fees or hypothetical calculation examples.
- *Complexity*: eight responding jurisdictions<sup>61</sup> raised concerns about the complexity of retail structured products and the ability of retail investors to understand the products. To address this concern India has adopted the measure of having a minimum ticket size of one million rupees so that products can be sold only to high net-worth individuals.
- *Misleading and deceptive conduct/mis-selling*: some responding jurisdictions explicitly raised concerns about either misleading and deceptive conduct or mis-selling.
- *Suitable or optimal investment choice*: a number of responding jurisdictions also raised concerns about suitability.<sup>62</sup> These jurisdictions also indicated that related to suitability is the issue of whether retail structured products represent good value investments.
  - France reported having its contribution to work which found that (based on a sample of retail structured products sold in Europe):
    - The fair value of the retail structured products is generally lower than the notional, with an average premium of 6 per cent excluding fees;
    - The counterparty risk embedded in retail structured products can be significant, with a counterparty premium of around 1.3 per cent on average;
    - The actual returns on capital protected products issued in EUR and GBP have been on average 2 percentage points lower than the risk-free rate. The results are less negative for products that matured before the 2008

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<sup>60</sup> Austria, Belgium, Finland, France, Mexico, Portugal and Quebec.

<sup>61</sup> Australia, Belgium, France, Iceland, India, Lithuania, Portugal and Switzerland.

<sup>62</sup> For example Australia, Belgium, France, and the United Kingdom.

financial crisis but the excess returns remain negative for most of them (the returns have been on average 1 percentage point lower than the risk free rate); and

- The distribution of expected returns varies widely according to the type of structured products and the specific parameters; some products seem to be designed for risk averse investors (such as capital-protected products) while others (such as outperformance certificates) seem to be designed for investors with a higher tolerance for risk.
- Portugal also reported having evidence that ‘in certain cases [the products] do not represent suitable or optimal investment choices for retail investors’.
- Other responding jurisdictions had reservations towards regulators’ assessment of the investment worth of products with the Hong Kong SFC observing that regulators should not be designing products, noting that moral hazard would result if a regulator were to conduct product testing, as regulators are in no position to assess whether a product is suitable for particular customers.
- The United Kingdom highlighted their recent focus on product governance and engaging with firms to determine whether products ‘truly do serve the needs of the customers to whom they are marketed’.

- **Complaints**

Most respondents did not provide detail on the subject matter and volume of complaints concerning retail structured products.<sup>63</sup> However, some respondents noted a significant increase in the number of complaints especially in relation to the collapse of Lehman Brothers. India noted, however, that there are very few complaints with regard to structured products.

Where detail was provided on the subject matter and volume of complaints, respondents stressed the mis-selling of retail structured products and inadequate disclosure to retail investors.

Examples included the following:

- *Portugal:* complainants focused on the failure to provide information on the investment risk and the expected return, the possibility of disposal prior to maturity or early redemption;
- *Australia:* in many complaints, investors did not understand the potential to lose money in products that were sold to them as capital protected but subject to conditions. Other complainants alleged inappropriate advice, and the failure of advisers to disclose or explain essential product risks and features, including the nature of the capital protection;

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<sup>63</sup> With the exception of Australia, Austria, Finland, France, Germany, Hong Kong, Lithuania, Malta, and the United Kingdom.

- *Hong Kong*: The Hong Kong Monetary Authority (the banking regulator in Hong Kong) received about 23,500 complaints involving structured products from January 2008 to June 2012. Over 99 per cent of these cases related to mis-selling (mainly related to Lehman-related products) and the rest related to unauthorized transactions, client agreement issues, service quality issues, etc; and
- *Malta*: complaints typically related to cases of mis-selling.
- **Unaddressed regulatory challenges**

The majority of respondents did not report any unaddressed regulatory challenges.

With those respondents that noted unaddressed regulatory challenges,<sup>64</sup> there were varying opinions.

Examples of these unaddressed regulatory challenges include the following:

- *Finland*: transparency of fees should be developed further;
- *United Kingdom*: standards in relation to the value for money of financial services products should be improved;
- *Australia*: there is no ‘suitability’ or ‘appropriateness’ test for both the issue of, and the provision of, general advice on a structured product to a retail investor;
- *India*: there is no specific framework applicable to principal non-protected structured products;
- *France*: a wide range of products are sold to retail customers without the same requirements on product/contract disclosures;
- *Mexico*: there is the need to eliminate the legal arbitrage between brokerage houses and advisers. In Mexico, brokerage houses are regulated and supervised by the Commission while advisers are not; and
- *Italy*: there is a need to take action at the EU level to address the remaining areas where the risk of product arbitrage is still substantial, particularly as regards investment products competing with investment funds which are not subject to comparable regulatory requirements.

- **Regulatory challenges across jurisdictions**

The majority of respondents observed no regulatory challenges across jurisdictions.<sup>65</sup> However, certain respondents expressed different views on this topic.

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<sup>64</sup> Australia, Austria, Finland, France, Italy, Mexico, Portugal, Slovenia and the United Kingdom.

<sup>65</sup> With the exception on France, Greece, Italy, Malta, Mexico, Portugal, Slovenia, The Netherlands and the United Kingdom.

Examples of issues which were raised include the following:

- *United Kingdom*: noted that, depending on the particular provisions in different EU directives, they can face some constraints on applying higher standards than in the directive to firms passporting into the United Kingdom from elsewhere in the European Economic Area;
- *The Netherlands*: noted regulatory demands, the quality of information brochures and marketing material differs among countries;
- *Malta*: the offering of structured products to retail investors involves complex questions of law in a number of jurisdictions which is proving problematic for passporting within the EU of these products; and
- *Italy*: noted an insufficient level of global convergence across the banking, securities and insurance sectors when it comes to the retail structured product market. This lack of convergence adds complexity to the system, presents obstacles to cross-border competition, as well as the proper detection of global financial risks.

- **Respondents' suggestions for 'best practice' regulatory approaches**

Various respondents provided suggestions for best practice regulatory approaches.

Some respondents expressed support for the adoption of a principles-based approach over a rules-based approach.<sup>66</sup> Other respondents pointed out the effectiveness of a rules-based approach in limited situations,<sup>67</sup> and some respondents support both approaches.<sup>68</sup>

Most respondents agree that a best practice regulatory approach should include clear guidelines and enforcement powers against intermediaries.

#### *Product intervention*

On product intervention respondents had differing opinions. For example, the United Kingdom believes that a best practice regulatory framework for dealing with retail structured products would include the ability to intervene swiftly and directly on products and remove them from the market where necessary to prevent consumer detriment.

On the other hand, Germany noted that product intervention should not be a part of a best practice regulatory framework. This was because of the belief that such a measure should always be the last resort and only be used if confidence in the whole financial market itself would be at risk.

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<sup>66</sup> Australia, Germany, Spain and Switzerland.

<sup>67</sup> Austria, Germany, Mexico and Slovenia.

<sup>68</sup> Brazil, Greece, Lithuania and Portugal.

### *Product regulation*

On product regulation respondents also had differing opinions. For example, Finland noted that regulation of the pre-issuance phase should cover product manufacturing and product approval processes within issuers. Hong Kong noted that for them it is not desirable to substitute the regulator's judgement for that of the investors in the pre-issuance phase as moral hazard will arise if investors become less wary of potential risks and trust *regulator-approved* products in the mistaken belief that they must be sound and safe.

### *Guidelines and enforcement powers against intermediaries*

Most respondents supported a best practice regulatory approach that includes clear guidelines and enforcement powers against intermediaries.

- *Portugal*: The Portuguese Comissão do Mercado de Valores Mobiliários (**CMVM**) said that a best practice regulatory framework for dealing with the complexity and sophistication of these products should include clear guidelines and enforcement powers against intermediaries to enhance protection of investors' interests in the sales process;
- *Austria*: noted that these guidelines and enforcement powers would be very useful in order to protect investors' interests and may be implemented in the course of the Insurance Mediation Directive; and
- *Italy*: noted these guidelines should provide, in line with the proposed IOSCO suitability principles, that business strategies of product manufacturers and distributors should ensure that structured products are designed, selected and distributed with a view to meet the best interests of the target market.

### *Cross-border measures*

There were different opinions of respondents on cross-sectoral issues and cross-border activities.

- *Belgium*: noted a best practice regulatory framework could apply a horizontal approach and regulate structured products, regardless of the wrapper form;
- *Italy*: noted that international cooperation for supervisory purposes should be strengthened in order to improve monitoring of systemic risks and investor protection especially where structured products are sold on a cross-border basis and stressed that an international best practice regulatory framework should apply the same rules regardless to the legal nature of the product and the type of distribution channel (to avoid regulatory arbitrage); and
- *Germany*: noted that cross-border measures should not be part of a best practice framework.

## **4. Regulatory effectiveness**

- ***Ex ante* cost-benefit analysis of regulatory framework**

Twenty-three respondent jurisdictions have not conducted an *ex ante* cost-benefit analysis of the regulatory framework. The United Kingdom, France and Italy, however, have conducted a public consultation on proposals on the retail structured product regulatory framework. During the process the key costs and benefits of proposals to the regulatory framework were analysed by each of those jurisdictions.

Key identified costs in those jurisdictions included:

- The cost of updating business models to increase product testing and focus on consumer needs in product development at a firm level (*United Kingdom*);
- The cost of improving governance arrangements (which includes one-off costs of reviewing strategy and ongoing costs of increased senior management discussions) (*United Kingdom*);
- The ongoing cost of improving identification of target markets and idea generation at a firm level (*United Kingdom*);
- The incremental ongoing cost of improved stress-testing and modelling per product (*United Kingdom*);
- The cost of improved selection and monitoring of distribution channels to facilitate distribution and provide support to intermediaries at a firm level (*United Kingdom*);
- The cost of producing a credit rating and appointing a third party valuation agency as required under law (*India*); and
- The cost of updating internal IT systems (*Italy*).

Key benefits identified in those jurisdictions included:

- Avoiding the negative impact that one or more problematic issues associated with retail structured products could have on retail investors and on confidence in financial institutions (*Belgium*);
- Improved matching of products to consumer needs by improved product design and distribution strategies (*United Kingdom*); and
- Providing strengthened investor protection as well as legal certainty to the industry and clarifying the regulatory expectations for intermediaries (*Italy*).

Generally these jurisdictions found that the expected benefits in terms of investor protection and the efficient allocation of resources outweighed the costs for implementation of regulatory changes.<sup>69</sup>

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<sup>69</sup> For example, in Italy and the United Kingdom.

- **Effectiveness of regulatory approach**

Eight respondents have conducted a formal or informal review of their own regulatory approach taken to retail structured products.<sup>70</sup>

Where a review had been conducted, generally, the jurisdiction has determined that the regulatory approach is seen to be more effective where the approach comprehensively targets the main problems identified in the retail structured products market (e.g., in Italy with the recommendations on illiquid products, in Belgium with the voluntary moratorium, in the United Kingdom with regulation targeting marketing and advice, and in France with the marketing position).

Examples of the types of reviews that have been undertaken include:<sup>71</sup>

- *Belgium*: A weekly review and presentation of the structured products market to the board and ongoing reviews of whether the moratorium requires clarification;
- *United Kingdom*: Reviews in response to market failings such as the mis-selling of structured capital-at-risk products, the failure of retail structured products backed by Lehman Brothers and retail structured product development and governance;
- *France*: A review of a position on the marketing of complex financial instruments;
- *Mexico*: A review on sales practices and disclosure;
- *Italy*: Regulatory and enforcement reviews due to detected failures by intermediaries to adopt internal organization arrangements and comply with conduct of business rules in connection with the distribution of illiquid financial products, including OTC products with a derivative component; and
- *Brazil*: An informal review process including the participation of the market participants, mainly through public hearings (leading to the introduction of regulation).

Where a review was undertaken, the key findings were the following:

- *Structured capital-at-risk products (United Kingdom)*: these products had often been sold to investors over the age of 60, often to generate income to supplement their retirement income. There were significant problems with marketing and advice and a common misalignment between the intended target market and actual investors;
- *The failure of retail structured products backed by Lehman Brothers (United Kingdom)*: problems were identified in relation to marketing and advice. Common failings included advice that did not match the customer's attitude to risk, an over-

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<sup>70</sup> Belgium, Brazil, France, Hong Kong, Italy, Mexico, Slovenia and the United Kingdom

<sup>71</sup> See footnote 8.

concentration of the customer's wealth in a single policy (therefore leading to substantial exposure to a single counterparty), and a failure to consider the tax implications of the recommended product. Many firms were also failing to conduct adequate due diligence on the products they recommended or to ensure that advisers understood the products and were competent to provide advice on them;

- *Retail structured product development and governance (United Kingdom)*: poor practice was identified in a number of areas, including (but not limited to) business models, product approval and development processes, stress-testing and modelling, selection and monitoring of distribution channels, information provided to distributors and consumers, and post-sales strategies in the event of product failure. The UK FSA believes that providers should ensure their products meet the needs of customers;
- *A position on the marketing of complex financial instruments (France)*: the application of the position had an impact on the majority of the marketing documents of complex debt securities and structured funds (around 150 quarterly). Generally, product risks and the calculation of payoff profiles were poorly presented. As a consequence, the AMF asked issuers and providers to enhance the presentation of the product risk and payoff profile in marketing materials and restructure products before authorisation, to make them simpler and respect the maximum number of mechanisms to be embedded in the payoff;
- *Sales practices (Mexico)*: there was no comprehensive regime ensuring that intermediaries act in the best interest of their clients or inform them of the risks adequately. It was also found that regulation did not effectively address conflicts of interest in sales practices. Rather, it was found that regulation for advisory services didn't establish a robust framework for due diligence, and adherence to 'know your client' and 'know your product' standards; and
- *Regulatory and enforcement issues in connection with illiquid financial products (Italy)*: action should be taken to address the remaining areas where the risk of product arbitrage is still substantial and more convergent supervisory practices should be pursued across borders.

- **Effectiveness of enforcement regime**

The majority of respondent jurisdictions have not conducted a review of the effectiveness of the enforcement regime. However, respondent jurisdictions generally have a variety of enforcement tools at their disposal to deter and sanction misbehaviours related to structured products. In general, respondent jurisdictions believe their enforcement regimes are largely effective where:

- A variety of enforcement tools are available to the regulator to sanction misconduct;
- The regulator is proactive in its enforcement activities and has targeted misbehaviour related to retail structured products where issues have been identified; and
- Regulatory changes have been implemented targeting certain retail structured products or market issues (whether enforcement-specific or otherwise).

The following respondent jurisdictions conducted a review of the effectiveness of their enforcement regimes:

- *Belgium*: a review of the launch of the voluntary moratorium found the reform to be largely effective (according to enhanced and regular contact between the sector and FSMA about product offers);
- *United Kingdom*: the FSA monitors effectiveness on an ongoing basis. For example, in 2009 the FSA consulted on the use of financial penalties following enforcement action. As a result of the consultation, the FSA decided to be more pre-emptive in the use of enforcement as a tool to improve industry practice;
- *France*: as a result of a review of the effectiveness of the enforcement regime, a more efficient process to compensate clients on mispricing related to funds (including structured funds) was enacted. Weaknesses identified in the review related to the marketing of complex products, regulatory arbitrage between legal wrappers and the lack of a level playing field. As a consequence, the AMF put in place a more effective framework to assess the mis-selling risk and consequently adjust the information and/or restrain the marketing scope, and has also worked on enhancing marketing requirements;
- *Hong Kong*: the enforcement regime is largely considered to be effective by its regulator. The Hong Kong SFC has ample resources dedicated to the enforcement function and actively pursues cases of all types;
- *Mexico*: issues hindering the effectiveness of the regime relate to gaps in enforcement powers; non-aligned sanctions available across the laws administered by the CNBV, the consistency and level of fine amounts; and the legal provisions restricting the disclosure of investigations and enforcement (i.e., powers to inform the market about its actions and procedures);
- *Malta*: in response to the International Monetary Fund's recommendation in the last Financial Sector Assessment Program to update policies in relation to structured products, the Malta Financial Services Authority adopted a new internal structure with sector-specific supervision. To increase the effectiveness of the regime, an enforcement unit is now responsible for reviewing actions and conducting investigations of licence holders who have or are suspected of having committed serious breaches of the law. The aim of this change is to further strengthen the regulatory and supervisory regime and to bring about a more consistent and effective enforcement process; and
- *Italy*: CONSOB has taken considerable enforcement actions with a view to ensuring proper application of intermediaries' internal arrangements and remuneration policies. CONSOB issued a number of sanctions, required intermediaries to undertake appropriate corrective measures (i.e., review business strategies and internal arrangements) and is still monitoring them in order to ensure that all will undertake effective actions.

**Issue 1 for consultation:** Do you think the survey results accurately reflect the regulation and markets of the respondent jurisdictions? Are there any other relevant facts, regulations or dynamics that the Working Group should consider?

## V Observations from Round Table Attendees

At the Round Table in London, details on the Working Group's activities to-date, including preliminary thinking on the content of this Consultation Report, were presented to the Round Table attendees. The attendees, in turn, were asked for their thoughts on the retail structured product market, contemporary regulatory developments and the proposed content of this Consultation Report.

### 1. Market

Attendees made the following points about the current retail structured product market:

- Many attendees commented that the retail structured product market suffered a contraction due to the recent financial crisis, with some modest recovery since then;
- In the current low interest rate environment, some attendees had observed a demand for yield-based products.
  - The low interest rate environment also makes capital protected products less attractive to issuers (due to the high initial price of the zero-coupon bonds required to structure the products);
- Equities are popular reference assets for retail structured products, with demand for credit-linked products increasing, particularly among high net worth investors;
- Some attendees noted that proprietary indices for retail structured products have become less popular while more traditional reference assets are becoming more popular.
  - Other attendees noted, in contradiction, a rise in popularity in active indices;
- There has been a trend towards simpler products. This has been driven both by investor demand and regulatory action.
  - Some attendees noted that the trend toward simpler products does not mean that risks are decreasing;
- One attendee noted an increase in shorter-term products, including products with thirteen month maturity dates, which may have tax advantages in certain jurisdictions;
- While the Survey results (as discussed above) noted that distribution chains are often vertically integrated (with issuer and distributor part of an affiliated group), some attendees noted a move away from this model, in which distributors would be distinct from issuers.
  - Some attendees made the point that they feel that issuers only have a general, high level, obligation when it comes to defining target markets and that distributors are more responsible for determining the suitability of the product for investors;

- Some attendees noted the heterogeneity of investors with respect to factors including financial sophistication (with some investors more able to understand products and risks than others), product preference, personal profile and risk appetite.
  - Some consumer representatives were of the view that certain investors have difficulty understanding the most simple of structured products; and
- Some attendees considered that a central lesson from the Lehman Brothers' bankruptcy was that it highlighted the credit risk involved with retail structured products.

## 2. Regulation and Possible Toolkit topics

Some attendees made the following points about regulation of retail structured products generally, and possible Toolkit topics specifically:

- There were mixed views on whether regulators should be more intrusive into and/or involved in the retail structured product market.
  - Some attendees welcomed more intrusive approaches while others expressed concern about the cost and implications of these approaches;
- Some attendees expressed support for consistent regulation across types of wrappers (e.g., across notes, funds, insurance contracts and deposits);
- There was also some support for regulators having a *value-chain* focus so that regulation is applied from issuance to distribution to post-sale issues;
- Attendees noted the risks of mis-selling by distributors and the importance of suitability assessments to promote appropriate sales of products;
- Some attendees emphasised the limitations of disclosure, and the importance of promoting investors' informed investment decision making and doing product testing;
- Other attendees expressed some concern about product governance and intervention initiatives;
- Some attendees stressed that suitability and investor education should be a responsibility of distributors;
- There was also emphasis on the importance of investor education;
- Some attendees commented on the interaction between the complexity of a structured product and its risk, noting that complexity can enhance returns but also introduce risk. Others noted that some relatively simple products may expose investors to high risk.
  - There was both support for, and concern about, regulators' focus on product complexity; and
- Some attendees emphasised conflicts of interest in the distribution chain.

- Some attendees said it would be unfair to force issuers to be responsible for the acts of distributors which are not related parties. They emphasised that it would be difficult for issuers to understand what distributors are doing to the degree contemplated by some of the possible Toolkit items.

## **VI Regulatory Toolkit**

### **1. Introduction**

This section sets out regulatory toolkit items that IOSCO members may consider in their regulation of retail structured products. The purpose of the Toolkit is to identify for IOSCO members some regulatory options that they could consider, as they see fit, in their regulatory approach to retail structured products in their jurisdiction.

No regulatory action is proposed to be mandated by the Toolkit and it is recognized that not every Toolkit suggestion would work within the regulatory regimes of all IOSCO members. Use of any specific regulatory tool would be at the discretion of each individual IOSCO member. Further, the use of any of the regulatory tools discussed below would be dependent upon the capacity of the relevant IOSCO member under its legal framework to use such a regulatory tool. The discussion of the regulatory tools in this paper does not imply that IOSCO members *should* have any particular legal capacity.

The Toolkit has been prepared by the Working Group with awareness that other work of IOSCO may also assist IOSCO members in their approach to retail structured products.

### **2. General rationale of Toolkit**

The Working Group believes the Toolkit could be useful to IOSCO members because of the unique challenges posed by retail structured products to members' investor protection mandates.

Retail structured products are the result of the retailisation of potentially complex financial tools. They combine derivative strategies with other financial instruments to deliver unique payoff structures. While these payoff structures may hold benefits for investors, they also pose various risks. The complexity of the products may cause investors to make suboptimal investment decisions due to a lack of understanding of the product. Additional investor protection measures may be warranted in light of this additional complexity and the difficulty investors may have in understanding the terms and risks of the products.

The appropriate level of investor protection, if any, in a jurisdiction may vary based on market circumstances including, but not limited to, the presumed sophistication of investors. Deciding upon the investor protection standards within any specific jurisdiction will involve the consideration by that jurisdiction's authorities of complicated questions of the degree of individual responsibility considered appropriate for the jurisdiction and the institutional capabilities of the relevant regulator.

IOSCO is also aware that the market for retail structured products is a global one. Dynamics and issuances in one market can be transferred to another market through globally active issuers and distributors. As with any financial product, differences in regulatory approaches to retail structured products, while often explained by unique domestic circumstances, can sometimes lead to regulatory arbitrage opportunities.

Given these factors, IOSCO believes that its members would benefit greatly from having an awareness of some regulatory tools available that jurisdictions can look to in order to address

their particular regulatory approaches or challenges that may arise with retail structured products. The Toolkit does not seek to impose uniform rules but rather to suggest certain commonly understood approaches to what can be done to address issues relating to retail structured products within specific jurisdictions.

### **3. Development of the Toolkit**

The Survey identified a number of points that the Toolkit seeks to address.

First, the results of the Survey identified a broad range of regulatory responses to retail structured products by the respondents. These responses involved disclosure regulation, issuer regulation, market intermediary regulation (including suitability) and other requirements, such as collateral requirements. The Toolkit draws upon the issues and regulations identified by Survey respondents to identify certain regulatory tools that IOSCO members may consider for their jurisdiction. The Working Group has been conscious that not all respondents would use all regulatory responses. For example, requirements concerning product intervention, particularly the more interventionist iterations of this regulatory technique, do not enjoy universal support, although some respondents obviously do use, or intend to adopt, such tools.

Second, the Survey identified some market dynamics that have helped inform the Working Group's development of the regulatory tools set out below. For example, the Survey identified a vertically integrated value chain for retail structured products where the issuer and distributor are affiliated entities (although we note that some Round Table respondents identified a move away from this model). These dynamics have helped inform the crafting of the tools set out below.

Third, the Survey highlighted some of the regulatory drivers that have prompted respondent jurisdictions to act. For example, the collapse of Lehman Brothers highlighted potential failures in intermediary conduct and product design. Some respondent jurisdictions also highlighted market failures in the form of information asymmetries, where those issuing and selling the products hold more information about the product than potential investors. Reported complaints in some respondent jurisdictions (i.e., around mis-selling or failure to provide information) are also important regulatory drivers in those jurisdictions.

Fourth, the Survey respondents identified some points that respondents viewed as suggested best practices for the regulation of retail structured products.

In addition to the Survey results, the development of the Toolkit has benefited from the diverse experience of members of the Working Group in their regulation of retail structured products.

### **4. Organisation of the Toolkit**

The Toolkit has five sections discussing tools for an overall regulatory approach and tools that are organised *along the value chain* of the retail structured product market. They cover:

- A potential overall regulatory approach to retail structured products;
- Potential regulation of the design and issuance of the products.

- These regulatory tools are concerned with the issuer’s processes for product design and development. Specifically, the tools concern investor identification, the use of modelling in the product development and disclosure processes, and product approval processes;
- Potential regulation of the disclosure and marketing of the products.
  - These regulatory tools concern the marketing of the product using disclosure documents (such as prospectuses) and other materials (such as brochures and websites). While these materials may be prepared by the market intermediary that faces the end-customer for the product, the material information is usually provided by the issuer of the product. The Toolkit offers regulatory options that are aimed at disclosure materials regarding retail structured products, including suggested approaches to disclosures of the features, risks and costs of retail structured products to retail investors;
- Potential regulation of the distribution of the products.
  - As noted above in Section II.2, the Suitability Principles concern the distribution of complex financial products and should be considered in addressing the issues raised here. They are not discussed in any detail in this section; and
- Potential regulation of post-sales practices (i.e., once the products are in the hands of investors).
  - These regulatory tools concern the last element in the value chain - the investor holding the product. Here, the Toolkit looks at what post-sales responsibilities issuers (and, consistently with the Suitability Principles, distributors) could have to the investors.

## 5. The Toolkit

### *(a) High level observations about regulatory approach*

- **Regulatory arbitrage**

**Regulatory tool:** In approaching the regulation of retail structured products, IOSCO members could consider the possibility of regulatory arbitrage impacting the effectiveness of either their or a peer regulator’s regulation of retail structured products.

Further, within their jurisdiction and to the extent it is within their legal framework and authority, IOSCO members could consider applying rules to retail structured products regardless of the base instrument or reference asset to reduce any applicable intra-jurisdictional regulatory arbitrage opportunities.

Accordingly, IOSCO members could consider, as they deem appropriate, coordinating, discussing or aligning their activities and rules on retail structured products with other agencies within and/or outside their jurisdiction.

**Rationale and comments:** Some respondents to the Survey identified a problem with inter-jurisdictional regulation.<sup>72</sup> For jurisdictions that are members of an integrated market (such as the EU), the issue of cross-border arbitrage is crucial as retail structured products may be sold across countries.

On intra-jurisdictional regulation, France identified the problem of products being offered via different product wrappers without the same degree of protection across the instruments.<sup>73</sup> Some members of the Round Table also highlighted the issue of varying regulation across product wrappers.

The regulatory tool seeks to make IOSCO members aware of potential regulatory arbitrage and suggests possible ways to evaluate and minimize them.

**Issue 2 for consultation:** 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?

- **Value chain focus**

**Regulatory tool:** The regulatory approach to retail structured products adopted by IOSCO members could address the whole *value-chain* of the retail structured product market to address specific (or common) challenges arising at every step of the product's life.

**Rationale and comments:** The Survey results revealed that structured products sold to retail investors take place in a production chain (from issuance to distribution to investment) with a number of related firms.<sup>74</sup> IOSCO members could adopt this regulatory tool to enhance, as needed or appropriate, all elements of the value chain within their market.

Certain industry attendees at the Round Table expressed support for a *value-chain* focus as a way to avoid weak links in the regulatory approach.

**Issue 3 for consultation:** Do you think that it would be useful for IOSCO members to take a *value-chain* approach to retail structured products? What issues do you think members could encounter in pursuing such an approach? How could those issues be overcome?

**(b) Toolkit – product design and issuance**

- **Intended investor identification and assessment**

**Regulatory tool:** IOSCO members could, if appropriate in their relevant legal framework, consider placing a responsibility on, or encouraging, product issuers to (a) identify and assess the type, class or features of investors that they intend to focus on for a structured product,

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<sup>72</sup> See page 26 above.

<sup>73</sup> See page 25 above.

<sup>74</sup> See page 11 above.

and (b) take steps, to the degree legally possible, to highlight for distributors and others that the product is aimed at these types of investors, as appropriate.<sup>75</sup>

If appropriate in their relevant legal framework, IOSCO members could include requirements applicable to issuers that would require them, prior to the sale of any retail structured product to an investor to:

- Analyse and evaluate investor needs and design product features to meet those needs;
- Promote the product in a way most likely to be understood by target investors, and that allows the identification by relevant parties of the types of investor who should – and who should not – invest in it;
- Provide that, as appropriate, internal controls are in place regarding the development of the product (including, where appropriate that the compliance or legal department has sufficient influence over the development process);
- To assess what investors may understand about the products that are proposed to be sold; and
- Focus on the post-sale matters discussed below.

To the extent that analysis of intended investors is encouraged or required under the legal frameworks for particular jurisdictions, it could involve some or all of the following:

- Investor risk profile;
- Tolerance for capital loss;
- Investment objectives;
- Investment timeframe (such as a consideration of the costs to investors of redeeming a product early and the implications for investors of products with uncertain maturity dates, like early knock-out provisions);
- The financial knowledge, experience and education of the target market; and
- Any common demographic characteristics (such as tax status and proximity to retirement).

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<sup>75</sup> Please see Principle 1 of the Suitability Principles (above footnote 2, 9) and its means of implementation for the application of these regulatory techniques to distributors. This Principle states: “Intermediaries should be required to adopt and apply appropriate policies and procedures to distinguish between retail and non-retail customers when distributing complex financial products. The classification of customers should be based on a reasonable assessment of the customer concerned, taking into account the complexity and riskiness of different products. The regulator should consider providing guidance to intermediaries in relation to customer classification.”

IOSCO members requiring or encouraging this type of analysis could also consider how, under their respective legal frameworks, relevant issuers could consider improvements to future products in light of their findings.

**Rationale and comments:** This regulatory tool is based on the view of some survey respondents that the manner in which issuers conceive of, and manufacture, their products can have an impact on investors. For example, the United Kingdom has introduced guidance on product governance that seeks to ensure issuers take into account investor needs when designing products.<sup>76</sup>

These jurisdictions that have authority over issuers believe that issuer assessments of their intended investors for a particular product may facilitate the issuance of products that are more likely to match the expected needs of investors. Issuers may understand what features will be useful or not useful for investors and be able to build products accordingly.

This concern is related to suitability – products that are designed around the needs of a particular class or type of investor are more likely to be suitable for an individual member of that class of investor. If issuers have a clear sense of the type of investor for whom the product is intended, then they may be more easily able to design a distribution process that ensures the product ends up with that type of investor, instead of another type of investor for whom the product is unsuitable.

**Issue 4 for consultation:** 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)? What do you consider to be the role of IOSCO members in the development and sale of retail structured products?

- **Use of financial modelling**

**Regulatory tool:** To identify the risks of the product and why it may not work, IOSCO members could consider requiring issuers to internally model<sup>77</sup> the potential performance of products when held by their target investors (to the extent permissible under the member's legal framework). If so required, modeling could consider scenarios where the reference asset:

- Performs well;
- Offers no returns; and
- Performs poorly (including where a counterparty involved in the product fails).

Regulators may also want to specify more detailed scenarios.

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<sup>76</sup> The guidance is available at: [www.fsa.gov.uk/static/pubs/guidance/fg12-09.pdf](http://www.fsa.gov.uk/static/pubs/guidance/fg12-09.pdf)

<sup>77</sup> By modeling, we mean the construction of financial models (e.g., in spreadsheets) that allow the performance of a structured product to be simulated using either historical or hypothetical future market movements.

To be accurate, IOSCO members may consider requiring the issuer to review whether the modelling would need to take account of any fees, costs or secondary market spreads that could be borne by the investor, including those that apply only at an early maturity of the product. Further, IOSCO members may consider requiring the issuer to review what assumptions underpinning the modelling would be fair and in line with market practice.

The modelling could allow issuers to determine a probability distribution of returns on the product.

The modelling and its results could be used to:

- Inform discussion in issuers' product approvals processes.
  - The modelling could 'stress-test' the product as it will perform when held by investors. This could:
    - Alert issuers to any potential problems in the product's performance after the investor purchases the product; and
    - Help issuers confirm that the product will perform as intended (and disclosed) to investors in a range of scenarios.
  - Issuers could be required to consider whether the modelling discloses that a proposed structured product offers good value for money in the sense that it offers investors an opportunity to achieve a positive return relative to the risk inherent in the product.
    - Further, firms could be required to take into account how all relevant fees and costs, including implicit premiums or marks up, on the product could affect the investors' final expected return (including where the product is terminated prior to its scheduled maturity) and to consider whether the distribution of the fee structure's impact on the return of the product is fair in this respect from the customer's perspective.
- Improve disclosure to investors.
  - IOSCO members could consider requiring issuers to disclose the results of the modelling (in an appropriate format) or the probability distribution of returns to investors.
    - In this regard, IOSCO members should be mindful that investors would obviously need to understand such financial concepts in order for the disclosure to be useful.
    - IOSCO members should also be aware that disclosure of possible returns could mislead investors if firms intentionally or mistakenly use incorrect assumptions and inputs in their modelling work.
    - Even if firms perform the modelling correctly, caution should be exercised to mitigate the risk that investors could place undue reliance on the results of the modelling. They may believe that the modelled returns will always occur

and may fail to analyse the product properly because they believe the modelling means they do not need to do this.

- Even if regulators do not require the more complex details of the modelling to be disclosed to investors, they could require that they be disclosed to the investors' advisers (on the assumption that the advisers are more financially literate) to assist that adviser in giving informed advice to investors.<sup>78</sup>
- IOSCO members could also require issuers to use the results of the modelling for purposes of determining that all relevant risks and features of the product are adequately disclosed to investors.<sup>79</sup>

**Rationale and comments:** This regulatory tool seeks to address two sets of concerns. First, some Survey respondents identified concerns with whether products had been tested prior to issuance or represent good value for money.<sup>80</sup> Consumer group representatives at the Round Table also raised the concern with products working as described by disclosure.

Modelling could help address these concerns. Modelling could be used to test whether products work as intended and enable the disclosure to accurately describe how the product works. Further, issuers will be able to assess whether products may represent good value for money. This may be a relevant decision point in any internal product approval process.

Second, some Survey respondents identified concerns about asymmetries of information and investor understanding of products.<sup>81</sup> Modelling can help address these concerns by improving disclosure (i.e., greater disclosure of the gains or losses a product *might* generate).<sup>82</sup> There is, however, the risk that investors do not understand the modelling or place too much reliance on it.

IOSCO members will therefore need to carefully weigh these tensions if they decide to incorporate modelling requirements within their regulatory settings.

**Issue 5 for consultation:** 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? 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.

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<sup>78</sup> See footnote 2 regarding advisers.

<sup>79</sup> Please Principle 3 of the Suitability Principles, which discusses in its means of implementation 1 the idea that distributors should, whenever they disclose or make available to their customers information regarding a complex financial product, give reasonable care to assist customers in making an informed decision by making them aware of the specific (net of cost) risk-return profile of the complex financial product.

<sup>80</sup> See page 23 above.

<sup>81</sup> See page 23 above.

<sup>82</sup> For example, India requires a detailed scenario analysis / valuation matrix showing value of structured products under different market conditions such as rising, stable and falling market conditions to be disclosed in a table along with a suitable graphic representation.

- **Product approval processes**

***Regulatory tool:***

*Internal approval process*

Working Group members have identified the following ways in which issuers could be required to focus on their product approval processes if appropriate in the relevant legal framework:

- Developing appropriate systems, procedures and controls for product design;
- Setting clear roles and responsibilities for the staff involved and a fitting remuneration that does not conflict with the interest of customers;
- Being able to demonstrate effective scrutiny and challenge from a customer perspective;
- Considering customer interests as part of the process and not allowing them to be overlooked as a result of commercial or funding pressures;
- Avoiding as much as possible or otherwise managing any conflicts between the firm and the customer to avoid detriment for customers; and
- Involving, as appropriate, the compliance function and obtaining approval by senior management.

In jurisdictions where there is a legal framework for authority over issuers, target market analysis, stress testing, pricing and modelling, and considerations of fees and value could be important factors to consider within the product approval process.

IOSCO members could also require issuers to review their process regularly so that it works as intended and takes into account regulatory or tax developments.

*Regulatory pre-approval*

IOSCO members with appropriate legal frameworks could also consider the introduction of a pre-approval process by regulators for products before they enter the market.

***Rationale and comments:***

*Internal approval process*

Many regulators have in the past focused their attention on the point-of-sale. The Survey indicates that regulators in some jurisdictions (for example in the UK and the EU more broadly) are increasingly introducing more focus on product design. For some regulators (but not others), distribution and disclosure standards are essential but not necessarily sufficient to prevent mis-sales. It may be that for these regulators, investor outcomes (in terms of structured products that deliver the intended investment returns) may be improved through setting requirements for firms earlier in the value chain. These regulators may consider that

if issuers are obliged to consider the matters set out in this regulatory tool, there could be fewer incidents of products reaching the wrong investors or being poorly designed.

Some regulators operate under a legal framework that is primarily disclosure-based (rather than ‘merit’ regulation of or intervention in market developments and/or distribution of retail structured products). Under disclosure frameworks, the individual investor is presented with all mandated and material information in order to reach his/her own investment decision

#### *Regulatory pre-approval*

Separately, in those jurisdictions that are legally able to and determine to use a pre-approval process before structured products are sold, such pre-approval may provide them: greater insight into the types of products being sold in their markets, and to the extent the IOSCO member has the ability to establish standards for such products, the opportunity to require that the products comply with the standards stipulated by the regulator before they go to market.

IOSCO members considering a pre-approval process should be aware, however, of potential moral hazards involved in such a process. 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 they have less responsibility in informing themselves about a proposed investment if they believe that the regulator has vetted or ‘checked’ the product for them. This may lead to less cautious investment behaviour and an increase in the risk of regulatory failure. If a pre-approval process is introduced, regulators could make clear what the process involves to manage the expectations of investors and ameliorate any moral hazard.

Further, if IOSCO members individually decide to implement a regulatory pre-approval process, they should be aware of the resources implications of such an approach. To work well, such pre-approval processes would need to be administered by individuals who understand how structured products work from a financial perspective, as well what requirements the products need to comply with. If the process is not appropriately resourced, there is the risk of regulatory failure where the process fails to achieve the outcomes the relevant IOSCO member wants from the process.

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

##### *Internal approval process*

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*

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.

- **Product standards**

**Regulatory tool:** Those IOSCO members that have a legal framework in which they may determine the structural and other requirements for products that may be sold by issuers to investors could consider establishing minimum product criteria for products that are sold to retail investors.

Such IOSCO members could establish criteria, for instance, for minimum capital requirements of issuers or guarantors of products or to oblige certain retail structured products to be collateralised using collateral that meets minimum standards.

Such IOSCO members may consider whether appropriate frameworks could be established that would set parameters for the types of products that may be sold to different types of investors.

If they are introduced, product standards could be based on consultation with industry, investors and other interested parties, in order to determine the most appropriate basis for the introduction of such standards.

A disclosure-based alternative to substantive product criteria impose on issuers could mandate or encourage the labelling of retail structured products. Such labelling could highlight particular features or qualities of retail structured products that the regulator believes are important to bring to the attention of potential investors.

**Rationale and comments:** Some IOSCO members (i.e., Belgium) have already adopted approaches that determine and limit product complexity based on, for example, the complexity of the product's calculation formula, overly complex investment strategies or a lack of transparency.

This would be helpful if a regulator, under their legal framework, wishes to intervene earlier in the product development process and preclude product features they believe to undesirable from reaching the market.

Under a disclosure-based approach imposed on issuers, IOSCO members may consider labelling as a tool. Australia, for example, has adopted a labelling standard for certain exchange traded structured products to help investors identify a particular feature of those products.

Again, IOSCO members should be aware of the moral hazard risks involved in becoming more involved in the establishment of standards for products (these are set out in the 'Rationale and comments' for the previous regulatory tool). Similarly, moral hazard could result from a regulatory determination concerning whether a product or product features are 'complex'.

<p><b>Issue 7 for consultation:</b> Do you think it appropriate that regulators play a role in setting product standards for retail structured products? If regulators do set such criteria, how should they do this, and what are the risks to the regulator and the market?</p>
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(c) *Toolkit – product disclosure and marketing*

- **Disclosure standards generally**

**Regulatory tool:** To improve disclosure standards of retail structured products as appropriate, IOSCO members could consider applying robust disclosure standards to retail structured products, which could include, depending on their applicable legal framework:

- Requiring that issuers' disclosure be consistent with the issuers' understanding of the intended investors' capacity to understand the disclosure;
- Requiring that all essential information about the product is available before the investor decides whether or not to buy the product;
- Requiring explanations concerning specific topics or items; and/or
- Requiring or encouraging the use of standardized risk indicators and/or minimum information about the product to allow for comparability.

**Rationale and comments:** Disclosure was identified by Survey respondents as a key feature of their regulation of retail structured products.<sup>83</sup>

Clear, complete and not misleading information about financial products at the pre-contractual phase is an essential precondition for investors being able to make a well informed investment decision. Further, comprehensiveness and accessibility is an important factor when it comes to the drafting of marketing or pre-contractual material.

Requiring explanation concerning specific topics or items could be a technique used by regulators (if they see fit) to help draw investors' attention to features of the product that require special attention prior to the investor making an investment decision.

For IOSCO members that adopt a regulatory tool that would standardize indicators, they should be aware that issuers could develop different forms of risk indicators. While firms should strive to address the same or similar risk and product descriptions, it is important that issuers be able to present risks and product descriptions that are reflective of their actual product. There is the risk that standardized indicators can be static and not aligned with investors' profiles.

While developing these 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 returns. These indicators could be regularly updated during the life cycle of the product. These indicators, if adopted, could be used in addition to other disclosure techniques and non-numerical behaviour information and based on reasonable assumptions.

The required disclosure of certain minimum information could be used regardless of whether a jurisdiction determines to use standardized disclosure or legends under their legal frameworks.

Standardized disclosure could result in boilerplate language that is not useful to investors.

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<sup>83</sup> See page 16 above.

**Issue 8 for consultation:** 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? 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?

- **Short-form or summary disclosure**

*Regulatory tool:* Consistent with their respective legal frameworks, IOSCO members could consider either allowing or requiring short-form or summary disclosure (which may or not be standardized). This short form or summary disclosure could be provided separately or included as part of a more detailed disclosure document to be made available to investors as appropriate in offering and selling retail structured products. IOSCO members could require these documents in addition to more lengthy disclosure documents.

IOSCO members could also consider supplying a document generator (or template) to ensure that documents are standardised to the greatest extent possible.

For those IOSCO jurisdictions that determine the use of short-form or summary disclosure appropriate, such disclosure could include among other matters:

- A short description of the functioning of the product;
- Underlying and duration of the product;
- Potential downside risk;
- Applicable guarantee schemes;
- Applicable guarantees built in the product and limitations thereof;
- Expected returns (and the probability of these returns) if the methodology is clear and not misleading;
- Scenario analysis (presentation of three scenarios : the worst, the break-even and the best cases)
- Risk indicators (can be based on a quantitative analysis);
- A qualitative description of the most important risk;
- Reasonable comparisons to alternative investment products;
- Fees and costs involved (at launch of the product, but also during the duration of the product and at early redemption or termination);
- What circumstances can give rise to early termination or redemption of the product; and
- Whether investors have the ability to surrender the product before its maturity.

**Rationale and comments:** Short-form or summary disclosure (whether prepared separately or as part of a more comprehensive disclosure document) can be made available to investors before investment, to support investors' understanding of the product and informed investment decision making and their comparison of different kinds of structured products or possible investments.

If the IOSCO member wants to provide that there also be short-form or summary disclosure that is prepared in connection with investments more generally, it could also encourage or require the use of such a document for giving the investor tailored advice about what the product might do for them in their specific situation.

The documents may allow benchmarking or comparison by investors across different products, which can be important part of the investment decision-making process. IOSCO members should be aware of the risk that investors may try to compare products with completely different product characteristics (for instance, solely on the basis of their expected returns).

**Issue 9 for consultation:** 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?

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?

What information do you believe IOSCO members could require to be included in a short-form or summary disclosure?

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?

- **Costs and fees**

**Regulatory tool:** IOSCO members could require full disclosure of the disaggregated costs, fees and charges for each of the components of the product as well as of the product itself including fees and costs relating to underlying components, as appropriate. Such costs, fees and charges could include explicit ones (e.g., commissions) and implicit ones (e.g., the costs or premiums effectively charged on the component parts of the retail structured product as well as the costs for redeeming the product).

IOSCO members could require this information to be disclosed to investors and their advisors, or, if appropriate in their relevant legal framework, choose to require the issuers or intermediaries to disclose it to the regulator.

**Rationale and comments:** This regulatory tool is seeking to address the information asymmetries and concerns about fees identified by respondents to the Survey and provide for disclosure of such information.<sup>84</sup>

The ability to compare different products and to understand the costs and fees of the products is an important element in the investment decision of an investor. If investors are able to compare the costs of similar or alternative products that deliver their desired strategy, then they may make a more informed investment decision.

Further comparability of structured products would be aided if the components of the products were unbundled and the costs or price of each component made clear to the investor. Structured products involve a base instrument, such as a bond, and a derivative. Each has a price and therefore a cost to the investor. The effect of such costs, fees and charges on the determination of the price of the products to investors may be information an IOSCO member would like disclosed to investors. Alternatively, regulators, if appropriate in their relevant legal framework, could require disclosure of this information to intermediaries who may then be required to explain it to the investors, as appropriate and as applicable in accordance with the Suitability Principles.

Disclosing these costs could allow the investor (or his/her advisor) to determine whether the prices being charged by the issuer are reasonable for the economic exposure and risk profile of the product and the relationship to the price being paid.

If IOSCO members do not think it appropriate to mandate this disclosure to investors or distributors, they may wish (if needed and if appropriate in the relevant legal framework) to receive this information themselves from issuers in order to monitor the market. If they determine appropriate under their legal framework, IOSCO members could then consider whether the pricing of any components of the product structure (based on prices charged by related parties) should be disclosed to investors. It should be recognized, however, that any assessment of the pricing of the product components by regulators may (i) encounter difficulties in determining the factors for such pricing; and (ii) give rise to the risk of the regulator assuming the role as a *price setter* and associated moral hazard.

It is important to note that this regulatory tool, if adopted, could also mean that the regulators, depending upon their respective legal framework, might need to assess the pricing of the products. Adopting IOSCO members should carefully assess their capacity to effectively exploit this regulatory tool.

**Issue 10 for consultation:** 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.

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<sup>84</sup>

See pages 23 and 25.

- **Use of fair value assessment**

**Regulatory tool:** IOSCO members could require issuers (or, consistently with the Suitability Principles, distributors) to disclose to investors the estimated fair value of retail structured products upon issuance as appropriate and in the periodical information addressed to the investors.

**Rationale and comments:** An accurate estimated fair value of a retail structured product in the hands of an investor is a guide to the secondary market value of the product once it has been issued. Being able to compare this value with the price paid for the retail structured product will help investors understand that the product will not always be worth that price post-issuance.

**Issue 11 for consultation:** 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?

- **Hypothetical scenarios**

**Regulatory tool:** IOSCO members could require issuers to describe clearly how the product works through hypothetical examples and disclose how the product generates income or returns as appropriate (e.g., the formula or the mathematical returns used to calculate payments to investors).<sup>85</sup>

**Rationale and comments:** Structured product returns are calculated by mathematic formulas. The operation of these formulas can be illustrated with examples of various presentations (e.g., three scenarios: the worst, the break-even and the best cases) to increase the likelihood of investors understanding how the product is intended to work. For reasons of uniformity and comparability, IOSCO members, if they wish, could prescribe the conditions the scenarios have to comply with.

This may involve requiring worst-case scenarios to be disclosed first.

**Issue 12 for consultation:** 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.

- **Backtesting**

**Regulatory tool:** IOSCO members could consider whether to require disclosure of any backtesting of the product's mathematical formula, provided the disclosure is not misleading.

**Rationale and comments:** Backtesting involves issuers running the mathematical formula used by a product with historical information. It could be used to demonstrate how the product would have performed based on historical data sets and depending on the assumptions used, could provide insight into how the formula works in a particular economic

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<sup>85</sup> See footnote 79 above for discussion of how the Suitability Principles could impose an equivalent requirement on distributors.

or market environment, but may not reflect actual performance or take into account all variables that can affect the product.

While backtesting may not necessarily be a good indication of future results, backtesting disclosure with fully disclosed assumptions, as well as presentation over a long period of time, can offer interesting insights.

In that regard, regulators using this tool could require issuers to check that the historical data set that is used is not be misleading. The data set could be selected to cover different market environments (e.g., one full economic/market cycle), and should be appropriate with the life of the product (e.g., a minimum of two times the life of the product could be considered).

Backtests could be performed using a range of datasets, which may enable the volatility of the potential return of the product to be made clear to investors. How the potential variance in returns is presented will need to be carefully considered in light of the investor's ability to understand the information.

Backtesting may not be applicable to all structured products e.g., a short-term product. IOSCO members should be mindful that mandating disclosure of backtesting may mean, depending on their respective legal framework, the IOSCO member may need to have the expertise to assess whether the disclosure is misleading or not. This issue may be particularly challenging when the underlying asset or reference asset is an index developed by the issuer of the structured product.

**Issue 13 for consultation:** 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?

- **Enhancement of informed investment decision making**

**Regulatory tool:** IOSCO members could put investor education measures in place to assist investors to understand issues and risks relating to the particular types of retail structured products that may be available in the market and provide suggested approaches that may assist investors in making investment decisions. One option may be learning modules that investors are required to take before investing in a retail structured product. This could help investors understand the product before they invest in it.

**Rationale and comments:** Retail structured products may be more complex, and thus more difficult to understand, than plain vanilla financial products. Further, investors may not engage with financial products, such as retail structured products, to the same degree as for other, non-financial services purchasing decisions. The Survey results highlighted the concern of some respondents with the ability of investors to understand retail structured products.

Investor education tools that facilitate the understanding of investors of structured products can help improve the skill-set of investors to engage with structured products. Such 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.

**Issue 14 for consultation:** What education tools could IOSCO members use when educating retail investors on retail structured products? What guidance could IOSCO provide to its members to facilitate better investor understanding of retail structured products?

*(d) Toolkit – product distribution*

As stated above, the Suitability Principles would be the basis for addressing issues identified with respect to the distribution of retail structured products. The scope of the Suitability Principles is discussed above in Section II.2.

• **Control over distribution channel by issuer**

**Regulatory tool:** If appropriate in their relevant legal framework, IOSCO members could consider whether to require or encourage issuers to take some level of responsibility for how products are distributed to retail investors. This would not require issuers to double-check the suitability of individual sales but would involve issuers evaluating whether the general distribution strategy developed by the issuer is appropriate for the target market and the product risks.

For example, IOSCO members could require or encourage issuers to obtain contractual undertakings from distributors that are designed to ensure that particularly complicated products are only sold upon advice or recommendation from distributors who have been able to demonstrate higher competence through additional qualifications.

**Rationale and comments:** A key concern raised by Survey respondents was mis-selling by distributors.<sup>86</sup> To address these concerns, it has been suggested by some that issuers may be able to exert commercial pressure on distributors to sell retail structured products in accordance with applicable laws through appropriately drafted contractual undertakings.

If IOSCO members see fit, and are legally able to, the responsibility of issuers could extend to:

- Adopting policies and procedures that are reasonably designed to ensure an appropriate distribution channel is chosen at the product approval stage; and
- Review whether the distribution channels used are appropriate to the target market and correspond to what was originally planned or envisaged for distributing their products.

This may involve the collection and analysis of data so the issuers can detect patterns in actual distribution compared to the expected distribution in the planned target market, and to allow the assessment of performance of the channels through which its products are being distributed. This collection and analysis of data could help issuers assure themselves that investors understand the nature and risks of the product and can bear those risks and potential losses as appropriate.

Issuers could act when they have concerns, for example by ceasing to use a particular distribution channel or distributor as appropriate.

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<sup>86</sup> See pages 23-25 above.

Once again, the issuers' responsibility should be distinct from the responsibility of distributors towards its customers.

**Issue 15 for consultation:** 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 type of requirements? Would the requirements have an effect on distributor behaviour?

*(e) Toolkit – post-sales practices*

**Regulatory tool:** IOSCO members could introduce regulatory measures covering the period after distribution of the retail structured products.

Broadly speaking, these could cover:

- Ongoing transparency/disclosure concerning the product
- An issuer's internal procedures; and
- Additional powers for the supervisory authority specifically addressing the post-sales period.

More specifically, these measures could include:

- Keeping investors informed with key information;
- Product review;
- Secondary market making;
- Guidance at maturity of the product;
- Cooling-off periods;
- Complaint handling procedures;
- Dispute resolution and compensation processes;
- Product intervention powers; and
- Making enforcement actions public.

These are measures are described in further detail below.

- **Keeping investors informed with key information**

IOSCO members could require issuers to disseminate or make available to investors information that will affect the value of their structured product during the life of the product. To the extent consistent with the Suitability Principles, and to the degree within the control of distributors, IOSCO members could consider applying similar requirements to distributors. Such information could cover:

- The financial performance and standing (i.e., credit ratings) of the issuer or other entities upon whose credit the products relies;
- Key events that affect the value of the product, such as trigger or credit events (particularly for reverse convertibles or other products with knock-in or knock-out optionality);
- The past performance of the product via an account that demonstrates how the value of the product has changed throughout its life;
- Any relevant changes to a product or to the issue; or.
- The investors' ability to dispose of the product.

- **Product review**

If permissible under the applicable legal frameworks, IOSCO members could require issuers (and/or, consistently with the Suitability Principles, distributors) to perform regular product reviews to enhance awareness about products and particularly about which products provide value to an investor.

IOSCO members may determine that it may be appropriate for issuer and/or distributors to use that information:

- During an internal new product approval process, to design future products according to the needs of a customer; or
- In exceptional circumstances, to take action with regard to an already issued product (for example, when products are failing to perform as intended due to a mechanical flaw in the product).

- **Secondary market making**

IOSCO members could consider requiring issuers (that are not distributors) who make a secondary market in these products to develop and disclose appropriate methods and criteria to describe the relationship between the price being paid and the secondary market value of the components of the instrument being resold. This is important because, where a product is not listed or lacks an early termination feature, investors can usually only divest themselves of the product at a price which is determined by a single purchaser (or limited number of purchasers) in the secondary market.

- **Guidance at maturity of the product**

IOSCO members could consider whether it is necessary to introduce a disclosure requirement so that investors are provided with information at the maturity of the product. Retail investors may find it very challenging to understand the return of a complex product if they do not receive detailed calculations, accompanied with clear information, about how a product has performed. IOSCO members may find it also useful to require the publication of the actual return of structured products issued or distributed in the recent past.

- **Cooling-off (i.e., time to think post-sale)**

In certain cases, IOSCO members could require a period which allows retail investors time to think carefully about the agreed investment and potentially rescind or cancel the sale contract if appropriate. How this period fits in with the investment order, sale and fulfillment process will need to be considered by IOSCO members taking into account their specific sale process regimes. Having such a period may be particularly important if there is no possibility to trade the product on a regular basis or in cases of purchasing during the product offering period.

- **Complaints**

Within the IOSCO objectives and principles of securities regulation it is generally acknowledged that intermediaries should have an efficient and effective mechanism for the resolution of investor complaints. IOSCO members might consider elaborating on this general requirement to strengthen complaints handling procedures by tailoring procedures to tackle the specific challenges posed by retail structured products. Complaints should be handled in a timely manner and with the expertise required for such products. Complaints data can also provide valuable information within the new product approval process (next to providing incentives for post-sale activities). IOSCO members could require information to be provided to them periodically about customers' complaints and how they are handled.

- **Dispute resolution and compensation**

In many jurisdictions, it is a recommended practice to provide a dispute resolution process for retail investors which also could provide for investor remedies. These processes could be organized within a supervisory authority as well as privately (by e.g., market participants) with oversight by the regulatory authority. A sufficient degree of independence should be ensured as well as expertise to deal with the cases in question. At a minimum, all retail investors could be permitted to bring claims without limitation to such a dispute resolution forum.

- **Product intervention powers (i.e., post-issuance banning)**

Consistent with their respective legal frameworks, IOSCO members' product intervention powers could allow a supervisory authority to ban a product or require changes to product features, if it turns out to be problematic from an investor protection perspective in the opinion of the authority. This power should be used only in a proportionate manner and only as the last resort to prevent damage for the financial sector as a whole. The sudden suspension of the trading of products can lead to an uncertainty in the market and negatively impact the interests of existing investors and issuers. Complex factors, such as how to rescind existing contracts and to treat the commercial positions of parties, would need to be worked through by individual IOSCO members. There are also moral hazard issues arising from the existence and use of these powers. Such issues were discussed earlier in this Consultation Report.

**Rationale and comments:** The holding period of the product is, for the investor, as important as the timing of the initial investment. The right time for an investor to sell an existing investment product is often as important as, or even more important than, the right time to get into the market. Structured products often perform in a non-linear fashion and, therefore, beside the classic buy and hold strategy, investors may be sometimes required to make trading decisions before the final maturity of the product. As well as the investor, the

performance of the retail structured product should be of interest for the issuer and the supervisory authority.

Structured products can run for quite long periods and, given the risks that may arise during their full lifespan, IOSCO members may wish to consider additional protections for retail consumers. The above regulatory tools suggested for consideration would help to deal with various problems after product sales.

**Issue 16 for consultation:** What other areas of activity could IOSCO members consider in the post sales period? Please explain. 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)?