

# **Regulation of Retail Structured Products**

## **Final Report**



**OICU-IOSCO**

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*This Final Report has been prepared by a working group of the Task Force on Unregulated Markets and Products (TFUMP). TFUMP is a multilateral group of staff experts from various IOSCO member jurisdictions. The regulatory tools, analysis and conclusions in this Final Report do not necessarily reflect the views of any one IOSCO member.*

## I Executive Summary

This Final Report sets out a toolkit (**Toolkit**) outlining regulatory options that IOSCO members may find useful 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.

The Toolkit has five sections with 15 regulatory tools that are organised *along the value chain* of the retail structured product market, from issuance to distribution to investment. They cover:

- (a) A potential overall regulatory approach to retail structured products.
- (b) 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.
- (c) 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.
- (d) Potential regulation of the distribution of the products.
  - IOSCO's *Final Report on the Suitability Requirements with respect to the Distribution of Complex Financial Products (Suitability Requirements)* concern the distribution of complex financial products and should be considered in addressing the issues raised here.<sup>1</sup> The Suitability Requirements are not discussed in any detail in this section.

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<sup>1</sup> FR01 *Suitability Requirements with respect to the Distribution of Complex Financial Products*, Final Report, Report of the IOSCO Board, January 2013, 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

(e) 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 Requirements, distributors) could have to the investors.

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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advice regarding the value of securities or the advisability of investing in, purchasing or selling securities. However, for purposes of this Final 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*

Generally, structured products encompass a broad range of typically complex financial instruments.<sup>2</sup> These instruments share the characteristic of having an embedded derivative that provides economic exposure to reference assets, indices or other economic values and pay-offs on predefined dates.

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>2</sup> A more detailed definition of structured products can be found on page 7 of this report.

<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's 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 behaviour 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 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 U.S. Securities and Exchange Commission (**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>. 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.

<sup>7</sup> Figure cited by the 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. SEC issued a comment letter to certain issuers of structured notes in an effort to improve disclosures with respect to future structured note offerings. A sample of the letter is available at <http://sec.gov/divisions/corpfin/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. 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/technique/multimedia?docId=workspace://SpacesStore/8f1c7f9a-90bc-4afa-94cf-4b5db749a747\\_en\\_2.1\\_rendition](http://www.amf-france.org/technique/multimedia?docId=workspace://SpacesStore/8f1c7f9a-90bc-4afa-94cf-4b5db749a747_en_2.1_rendition)

- **Belgium:** in 2011 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>

## 1. Preparing this Final Report

Due to these concerns, 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:

- 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.

To complete this mandate, a Working Group was formed.<sup>15</sup> This Final Report represents the fulfillment of the mandate.

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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/finservices-retail/investment\\_products\\_en.htm](http://ec.europa.eu/internal_market/finservices-retail/investment_products_en.htm)

<sup>13</sup> The regulation is available at: <http://www.cnbv.gob.mx/Paginas/NORMATIVIDAD.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>

<sup>15</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 Agency (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

*(a) 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's efforts, as governed by its mandate, have therefore looked along the 'value-chain' of the retail structured product market, from issuance to distribution to investment. For the purposes of this Report, we consider 'issuance' to encompass the issuance, origination or manufacture of retail structured products ('issuer', accordingly, has a similarly broad meaning).<sup>16</sup>

With respect to distribution, as noted above, IOSCO published the Suitability Requirements in January 2013. The purpose of the Suitability Requirements 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>17</sup> The Suitability Requirements define 'complex financial products' broadly and inclusive of 'structured investments'.<sup>18</sup>

The Suitability Requirements 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>19</sup>

The Working Group recognises that the Suitability Requirements would be the basis for addressing issues identified with respect to the distribution of retail structured products. We have referred to the Suitability Requirements where appropriate in the regulatory tools. In

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Québec Autorité des marchés financiers, Securities and Exchange Board of India, Securities and Futures Commission (Hong Kong) and the Securities and Exchange Commission (USA).

<sup>16</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 Final Report.

<sup>17</sup> See Suitability Requirements with respect to the Distribution of Complex Financial Products, IOSCO, January 2013, *supra* fn 1, page 8.

<sup>18</sup> *Ibid*, page 5.

<sup>19</sup> *Ibid*.

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 Requirements.

The Working Group has used 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) 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>20</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>21</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.

#### *(b) Survey and Consultation Report*

To complete its mandate, TFUMP asked IOSCO members in mid-2012 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 (**Survey**).

In the Survey, IOSCO members were also asked to offer their views on ‘best-practice’ regulatory approaches for dealing with the challenges observed in the market. Twenty six IOSCO members provided a response to the Survey.

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<sup>20</sup> While focused on retail structured products, the Toolkit items may prove useful to IOSCO members when evaluating other products.

<sup>21</sup> Customer Suitability in the Retail Sale of Financial Products and Services, Report of the Joint Forum, April 2008, page 11. Available at:

<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD268.pdf>

These Survey results were supplemented with feedback from attendees of a Round Table held in London in November 2012 (**Round Table**) and Working Group members.

In April 2013, IOSCO published a Consultation Report (with a two month consultation period), which set out the results of the Survey and built on the results by setting out a proposed regulatory Toolkit.<sup>22</sup> The primary purpose of the Consultation Report was to seek input from interested parties on the Survey results and the Toolkit.

The Survey informed the content of the Toolkit in four ways.

- (a) The results of the Survey identified a broad range of regulatory responses to retail structured products by the respondents.
- (b) The Survey identified some market dynamics that the Working Group saw as indicating the utility of specific regulatory tools.
- (c) The Survey highlighted some of the regulatory drivers that have prompted respondent jurisdictions to act.
- (d) 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 also benefited from the feedback gathered from attendees at the Round Table. 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>23</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. The Consultation Report sought 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.

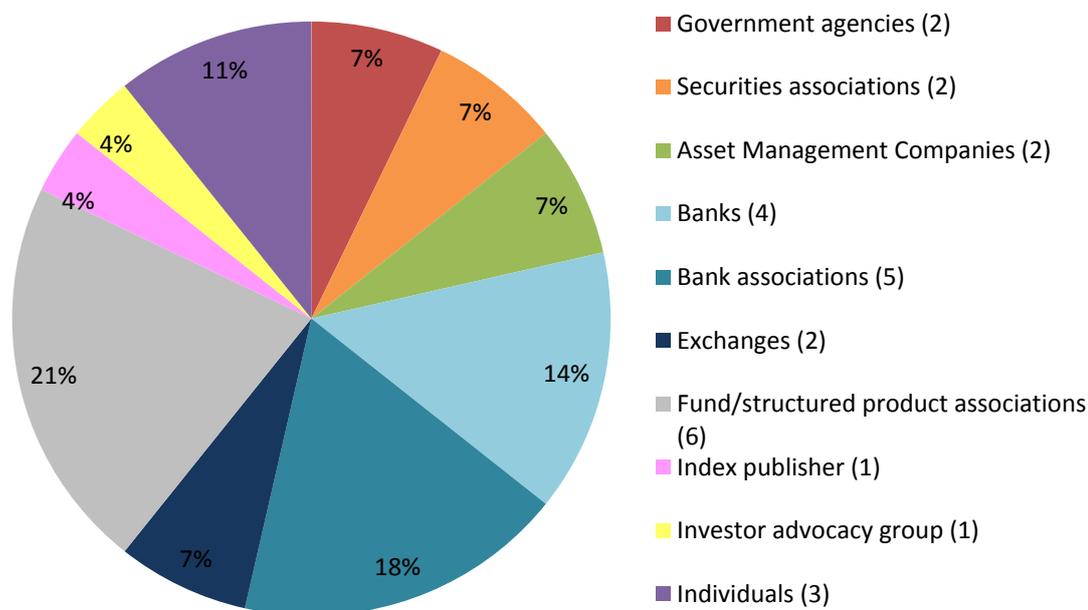
### *(c) Responses to Consultation Report*

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<sup>22</sup> CR05/13 *Regulation of Retail Structured Products: Consultation Report*, Report of the IOSCO Board, April 2013, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD410.pdf>

<sup>23</sup> Eight attendees represented European organisations; two represented Asia-Pacific organisations; and one represented a United States organisation.

The Consultation Report received 28 responses from a variety of entities. Most respondents were industry associations, which includes both bank associations and fund/structured product associations. The vast majority of respondents (17) were European. A breakdown of the types of respondents is set out below.



The Consultation Report asked for responses on sixteen issues:

1. *Whether the Survey results were accurate and whether there are any other relevant facts, regulations or dynamics that the Working Group should consider.*

Almost all respondents to this issue (13 of 15) indicated that the Survey results were accurate.

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

All respondents to this issue (17) agreed that inter- or intra-jurisdictional regulatory arbitrage is an issue within the market.

3. *Whether respondents thought that it would be useful for IOSCO members to take a 'value-chain' approach to retail structured products. What issues did respondents think members could encounter in pursuing such an approach? How could those issues be overcome?*

There were mixed views on whether it would be useful for IOSCO members to take a value-chain approach to retail structured products or not. Among those who approve (nine of 20), however, there was a concern that regulation be proportionate to the issue. This concern was also evident in responses that were against the value chain focus (seven of 20).

4. *Whether respondents thought 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 did they consider to be the role of IOSCO members in the development and sale of retail structured products?*

The majority of respondents to this issue (13 of 18) supported making issuers and/or distributors consider improvements to their market assessment process. Responses stressed a need for issuers and distributors to put reasonable emphasis on assessing the appropriate end market for retail structured products.

5. *Respondents were asked if the use of modelling as contemplated by the proposed regulatory tool could have an impact on the production of better value products and products that perform as intended or better disclosure. Respondents were also asked what they thought the risks would be with using modelling as contemplated by the regulatory tool. They were also asked if investors would benefit from having access to the results of the modelling and could IOSCO members require issuers to provide other information on the potential performance of the product.*

The majority of respondents to this issue (16 of 18) were against a requirement for issuers to disclose the results of internal modelling of products to investors because investors would not benefit from having access to the modelling. Regardless, most respondents (10 of 18) supported the use of modelling within the internal product design/manufacturing process.

6. *Product approval processes:*

#### *Internal approval process*

*Whether respondents thought 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 did respondents think it could 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?*

Most respondents to this issue (eight of 17) agreed that mandating internal approval processes for issuers is warranted because it may enhance investor protection by setting appropriate minimum standards.

#### *Regulatory pre-approval*

*Whether respondents thought it appropriate that regulators pre-approve products before they can be issued? They were also asked if the Consultation Report correctly described the benefits and risks of such a process. Respondents were asked what they*

*thought should be the criteria, standards and requirements for approval by the regulator.*

Most respondents to this issue (14 of 24) did not agree that it is appropriate that regulators pre-approve products before they are issued because it would introduce significant risks for investors and regulators.

7. *Whether respondents thought 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?*

Most respondents to this issue (15 of 20) did not think that regulators should play a role in setting product standards for retail structured products because it is morally hazardous, will reduce product innovation and hinder competition. It was seen as better to provide better information to investors to help them understand products.

8. *Respondents were asked 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? Did respondents 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?*

The majority of respondents to this issue (21 of 22) agreed that it is appropriate for IOSCO members to set issuer disclosure standards, but there was a general concern about heavy reliance on relatively static indicators or information. Respondents believed that a combination of simple but clear indicators, the disclosure of specific information and extreme risk scenarios is useful. Respondents also indicated that the European framework may generally be considered useful.

9. *Whether respondents thought 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 did respondents 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?*

There was support from all respondents to this issue (22) for short-form or summary disclosure with a clear key information disclosure document. There were, however, some concerns expressed by respondents (5 of 22) regarding what or how much information should be included in the document, particularly whether to include comparisons to other products.

10. *Whether respondents agreed that disclosure of disaggregated costs be made public or, alternatively, exchanged between the issuer and the distributor or the IOSCO member? Did respondents consider there to be an alternative mechanism to make disaggregated costs more transparent for retail investors? Do respondents think that the disclosure of such disaggregated costs would be useful to retail investors?*

There were mixed views on whether the disclosure of disaggregated costs should be made public, or exchanged between the issuer and distributor or IOSCO member, although a plurality were against (11 of 23) such disclosure. Even though there is general consensus on the usefulness and need for transparency and disclosure, those respondents that opposed the disclosure of disaggregated costs did so on the grounds that they are difficult to understand and irrelevant (according to two respondents) or not useful (according to the other opposing respondents) for retail investors.

11. *Whether respondents thought that disclosing the estimated fair value of a structured product at the time of issuance will be helpful to investors.*

Twelve respondents (of 19) to this issue did not agree with disclosing the estimated fair value of a retail structured product at the time of issuance since they believe this would not be helpful to investors. These respondents said that the calculations models used by issuers differ and the subjective values embedded in the models are therefore not comparable.

12. *Whether respondents thought it appropriate that IOSCO members prescribe disclosure of hypothetical scenarios. If so, what should these scenarios be? Did respondents consider there to be an alternative/simpler method of disclosing scenarios to retail investors?*

The vast majority of respondents to this issue (19 of 21) supported the disclosure of hypothetical scenarios, because it is a useful tool that might help investors better understand products. Respondents believed that scenarios should be hypothetical and based on assumptions which should be clearly disclosed as examples but not an indication of the likelihood of future performance. It was seen as important that scenarios should not be misleading investors as well as for regulators not to require scenarios.

13. *Whether respondents thought 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?*

Most (16 of 22) respondents to this issue did not think that disclosure of backtesting would be useful to investors because it might be misleading and retail investors may assume less responsibility for informing themselves if a product has been 'tested'. Only some respondents (five of 22) supported such disclosure.

14. *Respondents were asked what education tools could IOSCO members use when educating retail investors on retail structured products and what guidance IOSCO could provide to its members to facilitate better investor understanding of retail structured products.*

Most respondents to this issue (15 of 16) agreed that education tools (e.g., investor guides and interactive online materials) may be useful to educate retail investors on retail structured products. Seven of these respondents, however, were against placing a

responsibility on IOSCO members, and rather contended that the responsibility should lie with distributors.

15. *Whether respondents thought 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. Respondents were asked what impediments might IOSCO members face in implementing these type of requirements. Would the requirements have an effect on distributor behaviour?*

Many respondents to this issue (15 of 18) did not agree that it would be appropriate for IOSCO members to require or encourage issuers to have more responsibility for the actions of distributors that distribute their products.

16. *After explaining various areas of post-sales regulation, respondents were asked what other areas of activity could IOSCO members consider in the post sales period. They were further asked if there are 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).*

Responses to this issue were mixed. Some respondents (11 of 21) were against imposing requirements on post sales of structured products because there is no need for stricter regulation. On the other hand, 10 (of 21) respondents considered that some requirements are useful and applicable whereas others are impossible to be implemented in their jurisdiction as the legislation cannot be modified (cooling off periods for instance).

#### *Impact of consultation responses on Toolkit*

The views expressed by respondents to the Consultation Report have been carefully reviewed and assessed by the Working Group.

These views have informed the preparation of the Toolkit in this Final Report, in some cases by prompting alterations to the regulatory tools as they were presented in the Consultation Report and in others by confirming the Working Group's understanding of the issues raised by specific regulatory tools. These issues are set out in the rationale and comments that accompany each regulatory tool.

Further, the consultation responses will continue to be useful after the publication of this Final Report. IOSCO members will be able to refer to the comments, as summarized above, if they are deciding whether and, if so, how to implement a regulatory tool within their jurisdiction.

### **III Regulatory Toolkit**

#### **2. Introduction**

This section sets out regulatory tools 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 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 is at the discretion of each individual IOSCO member. Further, the use of any of the regulatory tools discussed below is 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.

#### **3. 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.

#### **4. 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) A potential overall regulatory approach to retail structured products;
- (b) Potential regulation of the design and issuance of the products;
- (c) Potential regulation of the disclosure and marketing of the products;
- (d) Potential regulation of the distribution of the products; and
- (e) Potential regulation of post-sales practices (i.e., once the products are in the hands of investors).

#### ***High Level Observations About Regulatory Approach***

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##### **Regulatory Tool 1: Regulatory Arbitrage**

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>24</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>25</sup> Some members of the Round Table also highlighted the issue of varying regulation across product wrappers.

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<sup>24</sup> CR05/13 *Regulation of Retail Structured Products*: IOSCO, April 2013, fn 22, page 26.

<sup>25</sup> *Ibid*, page 25

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

### **Regulatory Tool 2: Value Chain Focus**

The regulatory approach to retail structured products adopted by IOSCO members could consider evaluating the whole value-chain of the retail structured product market to address specific (or common) challenges arising at every or a specific 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>26</sup> IOSCO members could adopt this regulatory tool to enhance, as needed or appropriate, all elements of the value chain within their market.

### ***Product Design and Issuance***

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### **Regulatory Tool 3: Intended Investor Identification and Assessment**

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, 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>27</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

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<sup>26</sup> *Ibid* page 11.

<sup>27</sup> See *Suitability Requirements with respect to the Distribution of Complex Financial Products*, IOSCO, January 2013, supra fn 1 page 1. Please see Principle 1 of the Suitability Requirements 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.

- 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).

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>28</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.

The concern addressed by this regulatory tool is not whether a product is suitable for a specific, individual investor. Instead, it is focused on issuers considering the characteristics, nature and objectives of types of investors. 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.

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<sup>28</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)

#### **Regulatory Tool 4: Use of Financial Modelling**

To identify the risks of the product (particularly in the case of highly complex products) and why it may not work, IOSCO members could consider requiring issuers to internally model<sup>29</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, modelling could be used to identify how the product may function under a range of market conditions. 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 in a range of scenarios (in turn, this could assist issuers in developing appropriate disclosure to help investors understand the product's performance).
  - 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 the basis of disclosure to investors.

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<sup>29</sup> By modelling, 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.

- Regulators could require that modelling be disclosed to the investors' advisors (on the assumption that the advisors are more financially literate) to assist that advisor in giving informed advice to investors.<sup>30</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>31</sup>

***Rationale and comments:*** This regulatory tool seeks to address a number of concerns. Some Survey respondents identified concerns with whether products had been tested prior to issuance or represent good value for money.<sup>32</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.

Further, some Survey respondents identified concerns about asymmetries of information and investor understanding of products.<sup>33</sup> Modelling can help address these concerns by improving the basis of disclosure to investors.<sup>34</sup> There is the risk that investors would not understand the modelling or place too much reliance on it if it were disclosed to them. Regardless, the use of internal modelling still plays an important role in providing a supportable basis of disclosure to investors of the key risks and product features.

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

### **Regulatory Tool 5: Product Approval Processes**

#### *Internal approval process*

Consistent with their respective legal and regulatory frameworks, IOSCO members could consider a requirement for issuers to implement an internal product approval process to address specific (or common) challenges for product formation (taking into account the control of the product design, the interests of the target market and the management of

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<sup>30</sup> See Suitability Requirements with respect to the Distribution of Complex Financial Products, IOSCO, January 2013, supra fn 1 regarding advisers.

<sup>31</sup> *Ibid.* Please see Principle 3 of the Suitability Requirements, 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>32</sup> CR05/13 *Regulation of Retail Structured Products*, IOSCO, April 2013, fn 22, page 23.

<sup>33</sup> *Ibid.*, page 23.

<sup>34</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.

conflicts of interest). 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. This was also highlighted in a number of the responses received to the Consultation Report. 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.

IOSCO members may wish to explore whether a regulatory pre-approval process could expose them to any legal liability or challenge under the laws of their jurisdiction.

### **Regulatory Tool 6: Product Standards**

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 be 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'.

## ***Product Disclosure and Marketing***

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### **Regulatory Tool 7: Disclosure Standards Generally**

To improve disclosure standards of retail structured products, as appropriate, IOSCO members could consider applying robust disclosure standards to retail structured products. This could include, depending on their applicable legal and regulatory framework:

- Requiring that issuers' disclosure be consistent with the issuers' understanding of the intended investors' capacity to understand the disclosure;
- Requiring that all material information about the product is available before the investor makes an investment decision;
- 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>35</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.

### **Regulatory Tool 8: Short-Form or Summary Disclosure**

Consistent with their respective legal frameworks, IOSCO members could consider either allowing or requiring short-form or summary disclosure (which may or may 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.

IOSCO members making use of this regulatory tool could establish information requirements for the short form or summary disclosure, including, as they believe appropriate, limiting the information they think is necessary to describe the product. For those IOSCO jurisdictions

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<sup>35</sup> See CR05/13 *Regulation of Retail Structured Products*: IOSCO, April 2013, fn 22, page 16.

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 if the methodology is clear and not misleading;
- Scenario analysis (presentation of three scenarios: the worst, the break-even and the best cases);<sup>36</sup>
- Risk indicators (can be based on a quantitative analysis);
- A qualitative description of the most important risk/s;
- 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.

Additionally, IOSCO members could allow or require short-form or summary disclosure and let issuers decide the appropriate content of the disclosure (subject to a minimum standard of disclosure).

**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. Investors could also be made aware that these shorter documents should not be the only source of information for making investment decisions.

The documents may allow benchmarking or comparison by investors across different products, which can be an important part of the investment decision-making process. IOSCO

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<sup>36</sup> Further details on scenario analysis are contained in Regulatory Tool 11 on Hypothetical Scenarios.

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).

### **Regulatory Tool 9: Costs and Fees**

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>37</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 Requirements.

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. For example, disaggregated costs, fees and charges could be disclosed to distributors, and, where requested, to regulators. 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,

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<sup>37</sup> See CR05/13 *Regulation of Retail Structured Products*: IOSCO, April 2013, fn 22, pages 23 and 25.

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.

### **Regulatory Tool 10: Use of Fair Value Assessment**

IOSCO members could require issuers (or, consistently with the Suitability Requirements, 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. This disclosure could improve the ability of investors to understand the pricing of the products as well as to compare products.

**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.

There is not a single way to calculate the fair value and appropriate disclosure could alert investors to this issue.

### **Regulatory Tool 11: Hypothetical Scenarios**

IOSCO members could consider whether to require issuers to describe clearly how the product works through hypothetical examples and disclose how the product generates income or returns is appropriate or not (e.g., the formula or the mathematical returns used to calculate payments to investors).<sup>38</sup>

**Rationale and comments:** Structured product returns are calculated by mathematic formulas. The operation of these formulas can be illustrated with examples of scenarios where the reference asset:

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

Regulators could also consider specifying more detailed scenarios to increase the likelihood of investors understanding how the product is intended to work. For reasons of uniformity, comparability and investor protection, IOSCO members, if they wish, could prescribe the conditions the scenarios have to comply with.

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<sup>38</sup> See footnote 31 for discussion of how the Suitability Requirements could impose an equivalent requirement on distributors.

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

### **Regulatory Tool 12: Backtesting**

IOSCO members could consider whether to require issuers to backtest the product's mathematical formula, and to disclose the results to investors, 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 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.

### **Regulatory Tool 13: Enhancement of Informed Investment Decision Making**

Depending on their applicable legal and regulatory framework, IOSCO members could put in place investor education measures 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 online or print investor guides, investor seminars, online videos, investment warnings and interactive online materials), coupled with obligations of distributors under the Suitability Requirements regarding products that they sell, can provide further information to investors regarding the benefits and risks of particular types of retail structured products.

### ***Product Distribution***

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As stated above, the Suitability Requirements would be the basis for addressing issues identified with respect to the distribution of retail structured products. The scope of the Suitability Requirements is discussed on page 6 of this Report.

#### **Regulatory Tool 14: Distribution Channel Considerations**

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.

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>39</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 or regulatory standards through appropriately drafted contractual undertakings. This commercial pressure would supplement the legal requirement to comply with all applicable laws.

IOSCO members could, if consistent with their legal and regulatory framework, extend the responsibility of issuers to:

- Adopting internal policies and procedures that are reasonably designed to ensure an appropriate distributor is chosen at the product approval stage (this may relate to carrying out basic due diligence about the potential distributor, the intended product target market or determining possible training needs regarding the products to be distributed, considering the remuneration of the potential distributors sales staff); and
- Reviewing whether the distribution channels used are appropriate to the target market and correspond to what was originally planned or envisaged for distributing their products.

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<sup>39</sup> See CR05/13 *Regulation of Retail Structured Products*, IOSCO, April 2013, fn 22, pages 23-25.

Broadly, 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.

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

### *Post-sales practices*

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#### **Regulatory Tool 15: Post-Sales Practices**

Consistent with their respective legal and regulatory frameworks, IOSCO members could consider introducing appropriate relevant 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 consider requiring 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 Requirements, 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 consider requiring issuers (and/or, consistently with the Suitability Requirements, 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 consider requiring 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 Final 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.

List Consultation Responses

1. Amundi Asset Management
2. Association Française de la Gestion financière, France
3. Mr. Chris Barnard, Germany
4. Mr. Luca Barone
5. BBVA
6. Belgian Structured Investment Products Association (BELSIPA)
7. Boerse Stuttgart, Germany
8. Bundesverband Investment & Asset Management (BVI), Germany
9. Citicorp Finance India Limited
10. Deutsche Bank
11. Deutscher Derivate Verband (DDV), Germany
12. European Association of Co-operative Banks
13. European Banking Federation
14. European Fund and Asset Management Association (EFAMA)
15. European Structured Investment Products Association (EUSIPA)
16. Finance Watch
17. Financial Supervision Commission, Isle of Man
18. French Banking Federation (FBF)
19. German Banking Industry Committee
20. Japanese Bankers Association (JBA)
21. Japan Securities Dealers Association (JSDA)
22. Joint Associations Committee on Retail Structured Products (JAC)
23. Markit Group Limited
24. Natixis Asset Management, France
25. NYSE Euronext
26. Societe Generale
27. Superintendencia del Mercado de Valores, Panama
28. Academics, consumers associations, unions and other representatives of investors' interest