

**Disclosure of Risk - A Discussion Paper**

**Report by the  
Technical Committee of the  
International Organization of Securities Commissions**

*September 1996*

This report was prepared by the Technical Committee Working Group on Investment Management and approved by the Technical Committee during its September 16 and 20, 1996 meeting.

## I. INTRODUCTION

### BACKGROUND

- 1.1 In July 1995, the IOSCO Working Party on Investment Management (“WP 5”) agreed to examine issues relating to risk disclosure in the offering and marketing materials of collective investment schemes (“CIS”). In particular, WP 5 agreed to develop a Paper which would deal with “investor education and the problem of disclosure to CIS investors with particular focus on retail investors, specifically in relation to communicating risk and the limitations of regulatory involvement”. This Paper does not, however, deal with issues relating to Investor Education which may be the subject of a separate Paper.
- 1.2 In addressing these issues, WP 5 considered the core principles relating to disclosure in the Principles for the Regulation of Collective Investment Schemes, which has been adopted by the Technical Committee. In particular, Principle 10 on “Marketing and Disclosure”, acknowledges that whilst the approach of members of WP 5 to the content of disclosure documents and advertising varies, at a minimum, it is expected that there is an obligation on CIS to provide such information as an investor (new and existing) would reasonably require to make an informed investment decision and ensure that there is full, accurate and timely disclosure.
- 1.3 Some of the recent developments which highlight the need for disclosure of risk include the increasing popularity of the CIS as an investment vehicle generally and as a vehicle for retirement savings. In addition, many regulatory authorities are concerned that investment products (for example, derivative products which have various risk / return characteristics), are becoming increasingly complex which makes it difficult for average investors to understand and assess the risk of CIS investing in these products. These developments have highlighted the need to educate investors about risk in general and, more specifically, about the type and level of risk associated with certain CIS products.
- 1.4 Moreover, recent experience has demonstrated that fluctuations in the market, such as the volatility experienced in the U.S. mortgage-backed securities market in 1994 may affect CIS valuations in a manner that far exceeds public expectations based on historical data.

### SCOPE

- 1.5 Although it is recognized that the legal and regulatory regimes relating to risk disclosure may vary in different jurisdictions, many CIS operators and regulators are globally seeking ways to:

- (a) improve the presentation of risk factors in CIS offering documents and advertising; and
  - (b) ensure that broker-dealers, banks, investment advisers and other financial intermediaries adequately explain the risks of CIS investment to potential investors.
- 1.6 This Paper explores possible means of pursuing these goals, while also seeking to address the role of regulatory authorities with respect to risk disclosure both by CIS and by financial intermediaries. It is hoped that by improving risk disclosure of CIS products, investors will be better informed with more realistic expectations and that investor complaints relating to investment decisions will be reduced.

## **II. IMPROVING CIS RISK DISCLOSURE**

### **2 THE GOAL OF RISK DISCLOSURE**

- 2.1 Investment in a CIS, like any investment, carries with it certain risks (e.g., interest rate risk, currency exchange rate risk, credit risk, liquidity risk, market risk and inflation risk).
- 2.2 In order to make an informed investment decision, an investor who is contemplating investment in a CIS needs to understand both the potential rewards and the associated risks.
- 2.3 Principle 10 recognizes that the role of the regulator is to seek to ensure that investors are provided with all the information necessary to understand the risks involved in CIS investment.
- 2.4 Risk disclosure by a CIS should assist investors in understanding the relationship between risk and return, so that investors evaluating CIS performance do not focus solely on return, but also on the risk assumed to produce the return. Risk disclosure should help investors assess whether a CIS's potential return is an adequate reward for the risks taken.
- 2.5 Describing the risk associated with a particular investment product is usually complex. Also, investors have different investment objectives and different appetites for risk, as well as different abilities in understanding risk. Therefore, it is difficult to draw general guidelines for disclosure that take into account all these factors. Certain types of risk disclosure may not be appropriate even though they provide an overall picture of a particular fund. For example, assigning a level of risk (by way of numerical rating) to a CIS, with higher levels of risk deemed to be negative and lower levels deemed to be positive may not be appropriate for different types of CIS or investors and may not be possible from a regulatory perspective. Alternatively, where a particular index is commonly used to provide a risk rating, or where the link

with the CIS investment objectives is very close (e.g. bonds and sensitivity) it may be appropriate for the index to be disclosed to potential investors.

- 2.6 Instead, the goal of risk disclosure should be to:
- (a) provide an investor with sufficient information about CIS risk to evaluate whether the CIS is an appropriate investment vehicle to meet the investor's personal needs within the available investment time horizon, considering the investor's overall investment portfolio; and
  - (b) provide information in an easy to understand format, having regard to the type of investor.

### **3 THE ROLE OF REGULATORY AUTHORITIES IN IMPROVING RISK DISCLOSURE IN CIS OFFERING DOCUMENTS**

#### ***Purpose of the Prospectus***

- 3.1 The purpose of requiring a CIS to provide potential investors with a prospectus or other offering document is to ensure that investors are given sufficient information on which to base an investment decision. Because of prospectus disclosure liability, CIS prospectuses may however, become primarily “legal” documents, as opposed to “disclosure” documents. Many CIS operators encounter difficulty in achieving an appropriate balance between fulfilling all legal and regulatory requirements, and at the same time providing a “user friendly” marketing document which adequately describes the risk associated with a product.
- 3.2 If the prospectus is drafted primarily for the purpose of insulating the CIS from liability, the disclosure may be lengthy and highly technical, particularly if it is not the primary tool for marketing the CIS (either because other documents may be given to investors or because CIS units are sold through financial intermediaries). Moreover, a CIS prospectus may focus on the risks of particular investments that the CIS may make, rather than on the overall risk of investing in the CIS. This may make it difficult for investors to understand the aggregate risk level presented by the CIS itself as an investment.

#### ***Options for Improvement***

- 3.3 The strategies or policies that regulators may adopt in relation to risk disclosure by CIS vary amongst jurisdictions. However, regulatory authorities should encourage simplified, plain language disclosure in the prospectus so that investors are provided with comprehensible, balanced information on which to base an investment decision.

Regulatory authorities may wish to encourage implementation of this objective by using one or more of the following approaches:

3.3.1 Indicating support for the preparation and publication of “key features” or synopsis or profile of the CIS. These key features could be presented in a brief form at the beginning of the prospectus (for instance, as a profile or synopsis), and expanded upon in the body of the prospectus. Key features could include the following kinds of significant disclosure items:

- (a) information regarding CIS investment objectives;
- (b) investment strategies, information on risk and appropriateness of investment (e.g. the characteristics of an investor for whom the CIS may be an appropriate investment);
- (c) fees and expenses;
- (d) past performance of a CIS;
- (e) purchase, redemption and distribution procedures;
- (f) identity and relevant experience of CIS operator, portfolio manager, investment adviser, trustee or depositary and auditor in similar schemes; and
- (g) a description of factors relating to risk that may be material to potential investors.

Alternatively, provision could be made for a CIS to be permitted to issue a “concise” prospectus or offer document prior to the offer or sale of CIS units and an additional more detailed technical document (such as a “Statement of Additional Information”) could be made available to investors free of charge upon request.

3.3.2 Providing support for the establishment of disclosure best practice guidelines by industry associations. These best practice guidelines should not be seen as a substitute for the general disclosure obligations under the law, but as factors to be considered when drafting CIS prospectuses based on industry experience.

3.3.3 Issuing regulatory guidelines on discrete issues concerning disclosure in CIS prospectuses. For instance, discussion about any of the “key features”, or discussion about what is considered acceptable disclosure based upon regulatory review experience of CIS prospectuses.

3.3.4 Acknowledging alternative methods of comprehensible communication in prospectuses. The use of graphs, tables and other pictorial representations in the prospectus is viewed by many as generally assisting investors in understanding the extent of the risk involved, the nature of the investment and in comparing CIS. For example, a CIS could be required to produce a ten-year total return bar graph in its

prospectus, which would include a bar showing the performance of an appropriate market index for comparison purposes. Where there is a comparison of products, the comparison should be fair and should not omit factors which are likely to be relevant to an appreciation of such a comparison by an investor.

3.4 Regulatory authorities may consider the following guidelines when encouraging implementation of the approaches listed above:

3.4.1 The ability of investors to understand risk in the context of a CIS prospectus may be enhanced by issuers focusing on overall risk disclosure, rather than risks of individual portfolio investments. Therefore, it is preferable for a prospectus to concentrate primarily on the CIS's broad investment objectives, its strategies to achieve those objectives, and the portfolio risks accompanying those strategies.

3.4.2 It may be preferable to use a narrative or pictorial means when describing the risk associated with a particular CIS investment, rather than assign a particular rating to describe the risk.

#### **4 ROLE OF REGULATORY AUTHORITIES IN IMPROVING RISK DISCLOSURE IN CIS ADVERTISEMENTS**

##### *Regulatory Concerns Associated with Advertising*

4.1 The concerns discussed above in connection with CIS offering documents are also present in the context of CIS advertisements, including CIS sales material. The goal of regulatory authorities should be to seek to ensure that CIS advertising (which the Principles define as “any activity or notice electronically communicated or otherwise which publicly calls or draws attention to a CIS”) portrays the investment in a balanced manner, emphasizing the potential risks of an investment as well as the potential return from the investment. It is also considered fundamental that regulatory authorities have the power to enforce withdrawal of advertising or take appropriate action against non-compliance.

4.2 Member countries of WP 5 take a variety of approaches to the regulation of CIS advertising. Principle 10.3 recognizes that it is essential that in all jurisdictions, CIS advertisements “must not contain information which is false or misleading or which is presented in a manner which is deceptive”. In the context of risk disclosure, it may be deemed to be a deceptive or misleading practice for an advertisement to refer to the possible benefits of a CIS investment without also providing a discussion of the risks of the investment.

4.3 In some jurisdictions, certain selling documents are permitted to be disseminated to investors, provided that they do not contain false or misleading statements and that the prospectus accompanies or precedes the

communication, thereby ensuring that investors do not receive sales documents unless they also have received the prospectus containing information concerning risk.

- 4.4 Alternatively, in other jurisdictions, certain selling documents are only permitted to be published or disseminated if they refer to the importance of a prospectus and its availability, and that units will only be issued on the basis of an application form which is attached to the prospectus.

### ***Options for Improvement***

- 4.5 To ensure that CIS advertisements do not contain misleading information, regulatory authorities may:
- 4.5.1 Require that advertisements intended for distribution to investors be reviewed for compliance with applicable regulations, either prior to the use of the advertisement or during the course of compliance examinations.
  - 4.5.2 Not wish to play a role in approving CIS advertising, but rather emphasize that the burden is upon the CIS (and its advisers) to issue an advertisement which is not false or misleading, contains no material information not contained in the prospectus and refers appropriately to the availability of the prospectus for all material information relating to the offer.
- 4.6 In some jurisdictions regulatory authorities may require certain advertisements to contain “risk warnings” to potential investors, where for example: the investment can fluctuate in value; or the investment is described as being likely to yield a high income or as being suitable for an investor particularly seeking income from the investment.
- 4.7 Certain sales material that is intended for distribution only to brokers and dealers and that is not passed on to investors (“dealers-use-only material”) may not be required to be filed with regulatory authorities. Dealer-use-only material should be clearly and prominently labeled to indicate that it has not been approved for distribution to the public and may not be copied by or used with the public. Such material should not contain false, misleading or deceptive information.

## **III. FINANCIAL INTERMEDIARIES**

### **5 THE ROLE OF FINANCIAL INTERMEDIARIES**

- 5.1 While some investors make their own investment decisions and invest directly in CIS units, many others seek financial and investment advice from an investment professional or financial intermediary.



- 5.2 Financial intermediaries may include banks, broker-dealers, investment advisers and financial planners. Because of the important role these parties play in the process of investment decision making by investors (e.g. by recommending CIS investments to investors), regulatory authorities may regulate these financial intermediaries in a number of ways. Regulation may encompass requirements that financial intermediaries meet certain competency standards such as qualification and training criteria. These criteria may include a specified level of education, financial or investment experience, professional examinations, membership of professional or other organizations, and continuing education requirements.
- 5.3 Alternatively, a regulatory authority may not impose specific qualifications on a class of financial intermediary, but rather may require that the qualifications of the person be disclosed to potential clients.
- 5.4 In addition, regulatory authorities may impose specific standards of conduct requirements on financial intermediaries when providing services to investors. For instance, a requirement that the financial intermediary make a determination that a particular CIS is a “suitable” investment based on the investment objectives and financial circumstances of the investor to whom the recommendation is made.
- 5.5 Some of the standards of conduct requirements imposed on financial intermediaries may be expressly incorporated in rules or legislation or may arise from a general duty of care owed to investors due to the fiduciary relationship that exists between the intermediary and investor. These standards of conduct may be enforceable by a regulatory authority, by a self-regulatory organization of which the financial intermediary is a member, or through private litigation against the intermediary for breach of the standard of conduct requirement.
- 5.6 Where there is a “suitability requirement” imposed on a financial intermediary, the regulatory regime may require that the financial intermediary obtain information from a client sufficient to make a suitability determination before providing any investment advisory services and as appropriate thereafter. Relevant information may include the investor's investment objectives, risk tolerance, investment time horizon, and the relationship of the proposed CIS investment to the investor's individual portfolio.
- 5.7 Again, the financial intermediary's obligations may vary depending on the sophistication of the customer and the specific transaction. For example, financial intermediaries selling CIS units to elderly, retired or first-time investors may have heightened obligations with respect to ensuring that a particular CIS product is appropriate for the investor. On the other hand, the processes that need to be followed when dealing with institutional clients that have a high degree of financial sophistication may be different.

## **6 OPTIONS FOR IMPROVING RISK DISCLOSURE BY FINANCIAL INTERMEDIARIES**

- 6.1 Some regulatory regimes may not directly require risk disclosure to investors. For instance, where a “suitability” requirement is imposed on a financial intermediary, that obligation encompasses processes to ensure that unsuitable recommendations are not made rather than rely on any direct disclosure of risks to enable the investor to make the decision as to suitability of the investment.
- 6.2 However, even where there is such a “suitability” requirement, the regulatory regime may require either as a specific obligation or as a matter of industry best practice, that financial intermediaries adequately disclose material facts to investors when recommending the purchase of CIS units. Material facts about the CIS product may include: the investment objective and policies of the CIS; historical performance; applicable expenses and charges assessed by the CIS or intermediaries; and risks of investing in the CIS relative to other investments. Disclosure of other facts may be required if circumstances reveal that the investor would regard a fact as material to his decision to invest in the CIS.
- 6.3 In some jurisdictions, financial intermediaries are responsible for delivering the prospectus and sales material of a CIS to the investor. The financial intermediary may be liable for oral representations made to a customer that are inconsistent with the disclosures in the prospectus and sales literature.
- 6.4 The regulatory regime may impose on financial intermediaries responsibility for developing and maintaining appropriate internal controls, and supervisory and compliance procedures, to ensure that CIS sales practices comply with all relevant rules and are consistent with high standards of commercial practice.
- 6.5 The regulatory authority conducting compliance reviews of financial intermediaries may review internal procedures and may review accounts for abusive transactions, such as those which involve excessive “switching” among portfolios to generate fees and unsuitable diversification, or generally where a financial intermediary recommends that an investor liquidate an investment and reinvest in another for the purpose of providing income to the intermediary.