Suitability Requirements with respect to the Distribution of Complex Financial Products

Consultation Report

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Foreword

The focus of this consultation report is on customer protections, including suitability and disclosure obligations, which relate to the distribution by intermediaries of complex financial products to retail and non-retail customers (as defined in individual jurisdictions). The term *distribution* is intended to have a broad and functional meaning, in order to cover the services of selling by the intermediary in its role as such including, in connection with that selling, advising, recommending and managing discretionary accounts/individual portfolios, which results in holdings by investors of complex financial products.

How to Submit Comments

Comments may be submitted by one of the three following methods **on or before Monday, 21 May 2012**. To help us process and review your comments more efficiently, please use only one method.

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

1. Email

- Send comments to Suitability@iosco.org.
- The subject line of your message must indicate ***Suitability Requirements with respect to the Distribution of Complex Financial Products***
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc) to create the attachment.
- Do not submit attachments as HTML, PDF, GIFG, TIFF, PIF, ZIP or EXE files.

2. Facsimile Transmission

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

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Send 3 copies of your paper comment letter to:

Mohamed Ben Salem
General Secretariat
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a *Public Comment on* ***Suitability Requirements with respect to the Distribution of Complex Financial Products***

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Chapter 1 - Background

1 Introduction

The financial crisis made clear that the growing complexity of financial products and financial innovation may make the associated investment risks less apparent to investors. Some of these products have unique features that may not be well understood. Typically, the level of complexity of a financial product's structure will affect the ease with which the risk/reward profile attached to the product may be understood. Moreover, in certain situations, intermediaries may provide incentives to staff to sell financial instruments that may not be suitable for their clients. This heightens the potential for unsuitable transactions, loss of investor confidence and market distortions.

Recently, questions have been raised about the extent of intermediaries' responsibility for assessing the suitability of structured investment products, particularly in light of the collapse of Lehman Brothers in mid-September 2008. That failure resulted in significant losses by investors in some jurisdictions who had purchased, among other products, Lehman *mini-bonds*[1]. For example, in Hong Kong and Singapore, so-called Lehman *mini-bond* notes were distributed to retail investors by banks and brokerage firms. In both Hong Kong and Singapore, the regulatory authorities have conducted formal investigations into allegations that there may have been misrepresentations to retail investors in connection with the sale of Lehman Brothers-related structured notes. These Lehman *mini-bonds* have also been sold in some European countries[2] including Spain and the UK. In Germany, certificates were sold by banks to several thousands of private investors. In addition, a large number of Spanish investors lost approximately €3 billion in connection with their investment in products issued by Lehman Brothers.

The UK FSA, jointly with the ombudsman service, initiated a process in order to look at issues in the wider structured products market, not just Lehman related products, in order to inform a more wide-ranging solution that reduces overall consumer detriment. On the other hand, these products appear not to have been sold to the retail public in Japan and the United States. Additional losses may have been suffered by investors who had purchased similar structured products from banks and brokerage firms.

In light of recent events, and following the G20 call for actions to review business conduct rules[3], the IOSCO Technical Committee (TC) approved in June 2009 a project specification

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1 These Lehman mini-bonds were not plain vanilla bonds, but rather complex structured derivative products linked to Lehman Brothers and issued with small denominations, in order to make them affordable to retail investors.

2 A number of such complex securities, such as covered warrants and asset backed securities, are also traded on exchanges, including European regulated markets. For example, complex products are traded on European regulated markets as follows: ABSs and negotiated covered warrants on the Irish Stock Exchange (see http://www.ise.ie/index.asp?locID=300&docID=-1 and http://www.ise.ie/index.asp?locID=8&docID=-1); structured notes, traded on the Luxemburg Stock Exchange; structured and exotic covered warrants, hybrid bonds and ABSs on Borsa Italiana; structured products on the Frankfurt Stock Exchange; and Exchange Traded Commodities on the London Stock Exchange.

3 At the G20 meeting held in Washington, D.C. on November 15, 2008, the Heads of State set forth a number of common principles for reform of financial markets that intertwined with IOSCO's current and prospective work. The key points include the promotion of financial markets integrity by, *inter*

mandating its Standing Committee on the Regulation of Market Intermediaries (TCSC3) to review the suitability obligations relating to intermediaries' distribution of complex financial products to investors (i.e. standards for intermediaries to assess whether a particular product matches the investment knowledge, experience, objectives and risk tolerance of a customer). A revised project specification was approved by the TC in January 2011 to also cover how jurisdictions generally apply customer protections, including suitability rules, to non-retail investors. The TC was interested in analyzing suitability issues arising out of and in connection with the recent market turmoil since previous IOSCO work on, e.g., point of sale disclosure, focused on disclosure related issues, rather than the issue of *know-your-customer* and suitability.

In September 2009, the TC published the final report on *Unregulated Financial Markets and Products*[4] (TC Report), which was drafted by its Task Force on Unregulated Financial Markets and Products (Task Force). The TC Report contains recommendations for regulatory action designed to improve confidence in the securitisation process and the market for credit default swaps (CDS). The TC Report recommends, *inter alia*, reviewing investor suitability requirements as well as the definition of sophisticated investor and strengthening these requirements, as appropriate, in the context of the relevant market.

1.2 Recent Previous Work in this Area: The Joint Forum

In 2008, the Joint Forum - of which IOSCO is a Parent Committee - completed a project and report that provided an in-depth analysis of customer suitability in the retail sale of financial products and services.[5] This current project is intended to complement the Joint Forum's work in this area.

The Joint Forum's report provides an overview of how supervisors and regulated firms across the banking, securities and insurance sectors address the risks posed by mis-selling of retail financial products, including related regulatory requirements. An important part of the work was to survey some 90 financial firms around the world as to how they deal with customer suitability, and manage the risks posed by mis-selling. The project sought information on how suitability requirements applied to complex instruments such as (but not limited to) options, hedge funds, variable insurance products, direct participation programs/limited partnerships and real estate investment trusts (REITs), but did not focus exclusively on that topic. The Report essentially reflected a fact finding effort and was issued prior to the financial crisis that became manifest in the fall of 2008.

1.3 Developing this Report

The focus of this consultation report (Report) is on customer protections, including suitability and disclosure obligations, which relate to the distribution by intermediaries of complex

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alia, encouraging "a review of business conduct rules to protect markets and investors". See *Declaration of the Summit on Financial Markets and the World Economy*, G20 Heads of State, November 15, 2008, available at http://www.g20.utoronto.ca/2008/2008declaration1115.html.

[4] See *Unregulated Financial Markets and Products*, Final Report, Report of the Technical Committee of IOSCO, 4 Sep 2009, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD301.pdf.

[5] See *Customer suitability in the retail sale of financial products and services*, The Joint Forum, April 2008, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD268.pdf.

financial products to retail and non-retail customers (as defined in individual jurisdictions). The term *distribution* is intended to have a broad and functional meaning, in order to cover the services of selling by the intermediary in its role as such including, in connection with that selling, advising,[6] recommending and managing discretionary accounts/individual portfolios, which results in holdings by investors of complex financial products.

The analysis distinguishes between the customer protections, including suitability/appropriateness/know your customer related standards, arising from the different types of selling-related services (e.g., advisory vs. non-advisory business) and the degree of customers' sophistication (e.g., retail customers vs. non-retail customers). Work has been done in order to ascertain what criteria members deem appropriate for applying these standards to both retail and non-retail customers and to consider how firms implement appropriate customer protections, including suitability, know your customer and disclosure requirements, in order to assess whether a product is adequate or appropriate to the specific customer.

As a first step, TCSC3 surveyed members regarding current regulatory frameworks with respect to conduct of business rules aimed at ensuring that complex financial products are suitable or appropriate to a particular customer. The survey included the review of the current criteria applied domestically to classify customers, products and their risks in the assessment of suitability, and management supervision of the sales process. The survey focused on requirements relating to suitability determinations in the members' regulatory frameworks with respect to retail and non-retail customers. It also elicited information regarding whether certain (or all) complex financial products are considered to be generally not suitable/appropriate for certain customers.

As a second step, TCSC3 surveyed members regarding required disclosures to customers, retail and non-retail, regarding the distribution of complex financial products. The survey covered to what extent, if any, disclosure requirements in the distribution of complex financial products may differ between different types of services or with respect to non-retail customers as opposed to retail customers.

As a third step, TCSC3 provided a survey to industry associations in order to solicit their views on suitability requirements and also to obtain information from them regarding their practices in implementing suitability requirements in connection with the distribution of complex financial products.

A summary of the outcome of the above surveys, including lessons learned from the financial crisis and the relevant actions undertaken by members, is included as an Appendix to this Report.

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6 It should be noted that for purposes of this report, the term *intermediary* in the United States securities sector refers to registered broker-dealers only, not entities that only provide investment advice, although registered broker-dealers may provide advice. This report and its principles would be applicable to such registered broker-dealers.

Chapter 2 – Glossary

For the purpose of this Report and the surveys answered by members, the relevant terms were defined as follows:

- **Complex financial products** – refer to financial products, whose terms and features are not likely to be understood by an average retail customer (as opposed to more traditional or plain vanilla investment instruments), where these products have a complex structure, are difficult to value (so that their valuations require specific skills and/or systems) and/or have a very limited or no secondary market (and are therefore potentially illiquid)[7]. The term generally includes, but is not necessarily limited to, structured instruments, credit linked notes, hybrid instruments, equity-linked instruments and instruments whose potential pay-off is linked to market parameters, asset-backed securities (ABSs), mortgage-backed securities (MBSs), collateralised debt securities, and other financial derivative instruments (including credit default swaps and covered warrants). The term does not include conventional equities, conventional bonds and exchange-traded standardised derivatives contracts. The said list is intended to be illustrative and non-exhaustive. The above criteria are proposed to be taken into account when determining the level of complexity of a financial product.

- **Disclosure** – refers to any requirement for the firm to disclose information to the client that could be material to the investment decision (including information on risks). In a sense, disclosure is intended to assist the client in making his/her decision, but is quite distinct from the requirement for a firm to make a determination of whether a particular product is suitable for the client.

- **Distribution –** covers in broad terms the services of selling by the intermediary in its role as such including, in connection with that selling, advising,[8] recommending and, where relevant, managing discretionary accounts/individual portfolios, which results in holdings by investors of complex financial products.

- **Intermediary**[9] – means a firm in the business of managing individual portfolios, providing investment advice, executing orders on behalf of third parties, dealing in or distributing securities (including carrying derivatives positions)[10]. In jurisdictions where banks are permitted to provide investment services, this term includes banks to the extent they are providing such services.

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7 Some of these complex financial products may be listed on an exchange, but nonetheless may be seldom traded and thus less liquid. Indeed, although the admission to trading of the product on an exchange may imply that it can be sold if desired, it cannot guarantee that there will not be large spreads or infrequent trading, thus making liquidation more difficult and time consuming.

8 See footnote 6.

9 For purposes of this Report, the term *intermediary* in the US securities sector refers to registered broker-dealers only.

10 The definition includes firms such as product providers that directly distribute complex financial products they produce.

- **Mis-selling** – generally refers to the situation where the firm sells a financial product to a client that is not suitable for that client.

- **Suitability** – includes any standard or requirement that an intermediary is required or expected to comply with in the distribution of financial products – including as mentioned in the provision of investment advice, individual portfolio management, or in offering for sale both with and without providing a recommendation - to assess whether the product being sold matches the customer's financial situation and needs. An assessment of the customer's financial situation and needs may include an assessment of the customer's investment knowledge, experience, investment objectives, risk tolerance (including risk of loss of capital), time horizon and/or capacity to make regular contributions and meet extra collateral requirements, and understanding of the product in question where appropriate. Suitability is intended to have a functional and all-encompassing meaning, in order to accommodate technical legal terms adopted in different jurisdictions. If different requirements apply to intermediaries in individual jurisdictions depending, for instance, on the type of distribution (e.g., investment advice, individual portfolio management, other investment services, etc.) and/or type of customer (e.g., retail, institutional, sophisticated, professional, etc.) and/or type of complex financial product, all these requirements are intended to be covered[11].

[11] For instance, as far as European countries are concerned, reference to suitability should be read to include the concepts of suitability (for investment advice and portfolio management) and appropriateness (for other, non-advised, services) under Article 19 of Directive 2004/39/EC (MiFID).

Chapter 3 – Brief overview of existing regulatory gaps and risks

Suitability requirements generally aim at ensuring that intermediaries only make suitable recommendations and that customers have the necessary expertise, knowledge and financial capacity to trade in financial instruments and to understand associated risks given their investment objectives. Suitability requirements reflect the general duty to act fairly, honestly and professionally and in accordance with the best interests of the client[12].

It broadly appears from the survey of regulators (for more detailed information see the appendix) that national suitability regimes incorporate the following elements:

i). conduct of business rules including, e.g., obligations to gather information on products and clients and their matching, as well as to warn the clients that certain products may be unsuitable for them. In addition, some jurisdictions prohibit the recommendation of unsuitable complex financial products to retail customers;

ii). internal control rules, including recordkeeping obligations, internal policies and procedures related to the implementation of suitability obligations; and

iii). enforcement actions, including both civil and administrative related to breaches of fiduciary/regulatory/contractual duties. In some jurisdictions, there may even be criminal liability for such violations.

In most of the surveyed jurisdictions, the suitability requirements applicable to complex financial products are the same as those applicable to other securities.[13]

Suitability obligations generally apply only when a recommendation or an advice is given, or discretionary services are provided, whilst a firm is generally able to sell a product to a client, even if it could be potentially unsuitable, as long as it does not recommend or advise the investment.

In some jurisdictions, with regard to non-retail customers, suitability obligations may be less stringent or inapplicable, through waiver or otherwise. Such non-retail customers may include regulated/licensed entities and, depending on the particular jurisdiction, certain individuals and companies or other legal entities who have a minimum net worth or demonstrated investment experience.

In light of the financial crisis, it has become clear to regulators that they should give increased attention to the distribution of complex financial products that may not be suitable for certain customers. This is particularly true where the *features* of such products are not readily understandable to less sophisticated investors. Indeed, anecdotal evidence suggested that intermediaries may have distributed to their customers complex financial products that were not suitable for them. As a consequence of the number of investor complaints received

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[12] The words "in accordance with the best interests of the client" should not be interpreted to suggest the application of a fiduciary standard in all instances. In some common law jurisdictions, certain intermediaries may be subject to the duty to act fairly, honestly and in good faith, while not being technically subject to a fiduciary standard of care.

[13] However, as noted below, in some jurisdictions, the application of suitability requirements may vary, depending upon the counterparty to the transaction involving complex financial products.

and in the light of the damages suffered by investors from the distribution of structured products to them, several authorities commenced supervisory and regulatory actions that in some cases are still on-going.

In some jurisdictions, suitability requirements can be high level rules and the actual application of these rules to complex products may not be so obvious. Following the financial crisis, some members have issued special guidance or recommendations that specify how general suitability rules should be applied to certain complex products.

One important risk is that certain customers may invest in products that they do not understand or which are inconsistent with their risk appetite or investment objectives. Additional risks include the possibility that certain complex financial products may be illiquid and difficult to sell, and/or that the product is subject to the issuer's credit risk (as was the case with Lehman Brothers mini-bonds) and/or involve a leveraged component which may multiply the risk.

Moreover, if the product is manufactured by the intermediary itself, the intermediary may be incentivised to sell its own products in order to generate revenues. This risk may be particularly high during crisis period, where firms may face difficulties in raising capital from the public and alternative sources of revenues may not be available.

TCSC3 believes, therefore, that it is appropriate to develop guidance on the concrete elements that should be taken into account when carrying out suitability obligations in connection with the distribution of complex financial products.

Chapter 4 – Proposed Recommendations

Over 20 years ago, the IOSCO Presidents' Committee approved a Report on International Conduct of Business Principles[14] and called upon all of its members, in a related resolution, to recognize these principles as expressing basic standards of business conduct for financial firms. These principles addressed intermediary obligations of honesty and fairness, due diligence, the provision of information by and for customers and the management of conflicts of interest. According to principle 4: "*A firm should seek from its customers information about their financial situation, investment experience and investment objectives relevant to the services to be provided*". The comment specifies that: "*This principle is a necessary element in enabling the firm to fulfill any suitability requirements*".[15]

A similar standard is folded into Principle 31 of the *IOSCO Objectives and Principles of Securities Regulation*[16] and relevant Methodology, according to which: "A market intermediary should obtain and retain from its clients any information about their circumstances and investment objectives relevant to the services to be provided"; and "*Where the activities of an intermediary extend to giving specific advice, the advice should be given upon an understanding of the needs and circumstances of the customer.*". These principles and their implementation have particular relevance with regard to the distribution of complex financial products, which may have features and pose investment risks that are difficult for many investors, even non-retail investors, to appreciate fully.

IOSCO has therefore decided to consult the public on the following draft principles that it is considering adopting in order to promote robust investor protection in connection with the distribution of complex financial products. In particular, the purpose of this section is to provide guidance on how general suitability requirements highlighted in the high-level principles below could be implemented with regard to the distribution of complex financial products[17].

In developing these draft principles, IOSCO took into account feedback from a number of industry associations representing market intermediaries and product providers as well as other organizations. TCSC3 is grateful to the organizations who shared their views.

With regard to the applicability of these principles, this Report does not seek to provide a definitive or complete list of complex financial products, but sets forth, in the glossary in Chapter 2, a set of criteria that help to identify such products. In order to enhance investor protection and ensure a level playing field among different distribution models, these

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14 See *International Conduct of Business Principles*, Report of the Technical Committee of IOSCO, 9 July 1990, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD8.pdf.

15 See *A Resolution on International Conduct of Business Principles*, Presidents' Committee of IOSCO, November 1990, available at http://www.iosco.org/library/resolutions/pdf/IOSCORES4.pdf.

16 *IOSCO Objectives and Principles of Securities Regulation*, IOSCO Report, 10 June 2010, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf..

17 As mentioned in para. 3 above, in most of the surveyed jurisdictions, suitability requirements apply to all investment products. However, consistent with the project specification for this project, the following recommendations are only focused on the distribution of complex financial products because of the enhanced risks to customers that they may pose.

principles should apply also to the direct sales by firms, including product providers, of complex financial products that they produce[18].

TCSC3 takes note of the expected report by the Task Force on OTC Derivatives on the regulation of Derivatives Markets Intermediaries. Please see that report, once published, for additional guidance on conduct of business obligations that apply to transactions in OTC derivatives between non-retail parties[19].

Finally, beyond the case of direct sales, it is recognized that product providers have an important role to play in ensuring that investment products are appropriately designed for the target market and that relevant information is made available and clearly disclosed to the relevant distributors. To that end, therefore, this issue will be referred to the Technical Committee of IOSCO for further consideration.

1. Classification of customers

Principle 1: 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 and services. The regulator should consider providing guidance to intermediaries in relation to customer classification.

The regulatory system should establish a process to distinguish between retail and non-retail customers, in light of the complexity and riskiness of the different products and services that an intermediary should take into consideration when assessing suitability.

Possible criteria for the qualification of a customer as a retail or non-retail investor include objective indicators based on:

- the nature of the customer (e.g., regulated vs. unregulated entity; person acting in a business capacity vs. consumer);
- financial status;
- financial experience (e.g., frequency and size of previous investments, relevant professional experience in the financial sector; relevant experience with asset class or product in question); and
- ability to assess independently, or through a disinterested advisor, the value and risks of the transactions.

In some jurisdictions, certain suitability obligations may be differentiated or waived (in whole or in part) depending on the customer classification. In other jurisdictions, such waivers are not available or permissible. Caution should be exercised so as not to develop an overly broad presumption or definition of non-retail investor that could inappropriately limit

[18] See definition of *intermediaries* above.

[19] It should be noted that some jurisdictions do not apply certain conduct of business (including suitability) requirements to certain intermediaries/counterparties entering into a swap transaction with each other, due to the presumed sophistication of the parties. In such jurisdictions, one or more of the following principles may not be applicable to such transactions.

the reach of suitability protections. Experience shows that presumptions may be inaccurate since they do not take into account the differences between entities, products and services. For example, during the recent financial crisis in some jurisdictions, some non-retail customers such as local authorities and municipalities appeared not to have had the ability to understand the risks they were exposed to, especially in the case of complex financial products. Accordingly, jurisdictions should consider whether additional protections are needed, particularly where public entities are involved.

Intermediaries should not automatically rely on the customer's demand for non-retail customer status or, where relevant, on the triggering of a given threshold or size. Intermediaries should be required to make their own assessments on the level of expertise and knowledge of the customer, giving reasonable assurance, in light of the nature of the transactions or services provided that the customer is capable of exercising his own independent judgment on the investment decisions and understanding the risks involved.

In those jurisdictions where the classification of customers is not determined by statute or regulation, the customer should be informed by the intermediary at the outset about what classification the intermediary has made and about the implications of such classification on the duties of the intermediary toward such customer.

A jurisdiction may allow customers who qualify as non-retail customers to demand to be treated as a retail customer. Moreover, intermediaries may be allowed to qualify and treat all customers as retail customers and afford them the corresponding higher level of protection[20]. Should the intermediary, however, become aware that the customer no longer fulfils the criteria that made him eligible for classification as a non-retail customer, the intermediary should be required to take appropriate action with respect to any subsequent transactions. The intermediary should update the information about their customers on a periodic basis to keep it current.

2. General duties irrespective of customer classification

Principle 2: Irrespective of the classification of a customer as retail or non-retail, intermediaries should be required to act honestly, fairly and professionally and take reasonable steps to manage conflicts of interest that arise in the distribution of complex financial products, including through disclosure, where appropriate.

According to Principle 31 of the IOSCO Objectives and Principles of Securities Regulation[21] and relevant Methodology: "*A market intermediary should act with due care and diligence in the best interests of its clients and protect their assets and in a way that helps preserve the integrity of the market*". Moreover, "*the regulatory framework should require [...] addressing any conflict of interest arising between its interests and those of its clients. Where the potential for conflicts arise, a market intermediary should ensure fair treatment of all its clients by taking reasonable steps to manage the conflict through organizational measures to prevent damage to its clients' interest, such as internal rules, including rules of confidentiality, proper disclosure, or declining to act where conflict cannot be resolved*."

[20] Indeed, for some intermediaries, treating all customers as retail clients may be more cost-effective than establishing separate categories of customers (e.g. professional clients). This practice should be considered legitimate, since it affords a higher level of investor protection.

[21] Supra fn 16.

The overarching high-level principle to act honestly, fairly and professionally and the general duty of good conduct should apply irrespective of the customer classification, including in those jurisdictions where intermediaries are authorized to provide services to investors whose level of expertise may permit a *waiver*, in whole or in part, of the protections offered by suitability rules.

Moreover, irrespective of any customer classification, intermediaries should be required to take reasonable steps to manage conflicts of interests and, where appropriate, clearly disclose the nature and/or source of conflict to the customer concerned before the provision of the service or the performance of the relevant transaction, so as to allow the customer to make an informed decision.

Subject to local regulatory requirements, when conflicts of interest are inherent to the transaction, such as a principal-to-principal counterparty relationship [22], the conflicts could be mitigated through additional disclosures, such as identifying how the intermediary's interests may be adverse to its counterparty's interest. Intermediaries should also have policies and procedures to assess whether the customer has sufficient knowledge to evaluate the transaction and to evaluate any conflicts of interest that are inherent to the transaction.

3. Disclosure requirements

Principle 3[23]: Investors should receive or have access to material information to evaluate the nature, costs and specific risks of the complex financial product. Any information communicated by intermediaries to their customers regarding a complex financial product should be communicated in a fair, comprehensible and balanced manner.

According to Principle 31 of the IOSCO Objectives and Principles of Securities Regulation[24] and the relevant Methodology: "*A market intermediary should disclose or make available adequate information to its clients in a comprehensible and timely way so that the client can make an informed investment decision. It may be necessary for regulation to require a particular form of disclosure where products carry risk that may not be readily apparent to the retail client. Recruitment and training should seek to ensure that staff who provide investment advice understand the characteristics of the products they advise upon*".

Complex financial products may have features and pose investment risks that are difficult for many customers, even non-retail customers, to appreciate fully. For example, in some instances, these products link high return rates to certain favourable, but unlikely scenarios,

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22 While most securities regulators do not define a principal-to-principal transaction *per se*, such a transaction might be described as one where the trader executes the trade for its own account rather than the account of a client. As such, such a principal-to-principal transaction is distinguished from a traditional intermediary relationship where a broker acts as agent on behalf of another party, and where such agent does not share in the economic risk of the transaction or participate in any benefit arising from the transaction, and receives a fee for the service.

23 Although the focus of this, as well as other principles, is on intermediaries, nothing in this section is meant to prevent regulators from imposing obligations on issuers with regard to disclosure, including, e.g., requiring issuers to provide offering materials for registered securities detailing product information.

24 Supra fn 16.

which may be displayed as a client-attraction factor. When the probability of the promoted scenario is low, the expected return of the products may actually be lower than the expected return of traditional retail savings products.

Therefore, whenever intermediaries disclose or make available to their customers information regarding a complex financial product, whether as a matter of firm policy or regulatory mandate, special care should be given to assist customers in making an informed investment decision, particularly in evaluating the specific risk-return profile of the complex financial product. This means, for instance, that information on complex financial instruments communicated to customers should present a fair, comprehensible and balanced picture regarding both the risks and potential benefits they pose, especially when the product's performance is sensitive to extreme scenarios. In particular, performance scenarios should be based on reasonable and conservative assumptions, and should be presented in a way that does not overstate the potential benefits and understate the risks of the complex financial product.

Complex financial products should not be presented as if they were non-complex plain-vanilla securities; rather customers should have access to a description of the different components of the product and how these components interact and affect the risks.

Stricter disclosure requirements should apply whenever the intermediary advises or otherwise recommends the purchase of a complex financial product to retail customers. For example, the regulatory system should require that intermediaries recommending the purchase of a complex product deliver information to the customer on the nature, specific risks and other material aspects of the complex financial product. Moreover, as acknowledged under Principle 1 above, based on the classification of customers in some jurisdictions, there are investors who may not fall within the scope of a retail customer, but may not have the level of skill or knowledge in order to be able to gather and assess the information needed on the purchase of a complex product. This could be the case where customer meet certain income thresholds, but yet would not have the level of sophistication of an institutional investor. In these instances as well, regulators should consider applying stricter standards of disclosure.

As stated in Principle 31 of the IOSCO Objectives and Principles of Securities Regulation[25] and the relevant Methodology, an intermediary should: "*Addressing [address] any conflict of interest arising between itself and those of its clients. Where the potential for conflicts arise, a market intermediary should ensure fair treatment of all its clients by taking reasonable steps to manage the conflict through organizational measures to prevent damage to its clients' interest, such as internal rules, including rules of confidentiality, proper disclosure, or declining to act where conflict cannot be resolved*". For example, proper disclosure should include any compensation and/or fee that the intermediary may earn as the result of the distribution of a particular complex financial product, and other non-monetary benefit that might accrue to the intermediary as a result of the distribution.

Customers should have reasonable access to information that fosters their ability to track costs and charges relating to the purchase of a complex financial product including, ideally, if practical and feasible, on an unbundled basis. In addition, when a liquid secondary market for a complex financial product does not exist, the customer should have access to enough

[25] Supra fn 16.

information to know that the product is illiquid, including the means and range of timing for disinvestment[26].

Moreover, where practical and feasible, intermediaries should seek to provide customers with comparative information concerning appropriate alternative investment products.

When recommending a long-term investment in a complex financial product, intermediaries should alert the customer concerned that the investment recommended may not remain suitable over time.

Finally, as recommended under Principle 31 of the IOSCO Objectives and Principles of Securities Regulation[27] and the relevant Methodology, regulators should consider requiring a particular form of disclosure where products carry risks that may not be readily apparent to customers, particularly retail customers. In particular, regulators may require the employment of simplified and user-friendly format summarizing the key features of the complex financial product.

4. Protection of customers for non-advisory services

Principle 4: Even when an intermediary sells to a customer a complex financial product on an unsolicited basis (no management, advice or recommendation), the regulatory system should provide for adequate means to protect customers from associated risks.

Typically, the greater reliance placed by the customer on the intermediary justifies the application of stricter suitability requirements where intermediaries recommend the purchase of a complex financial product, including where the intermediary provides individual portfolio management or investment advice. Nonetheless, all regulatory systems should provide for adequate minimum protections even where a customer purchases a complex financial product on an unsolicited basis.

In Europe under the Markets in Financial Instruments Directive (MiFID), such protections are risk-based and vary depending on the level of sophistication of the customer and the complexity of, and the risks associated with, the financial products or their investment strategy and structure[28]. In Asia, some jurisdictions, such as Japan, Hong Kong and Singapore, require intermediaries to assess customers' knowledge and experience about derivative products before providing services to them. Other jurisdictions may seek to protect customers under such circumstances through anti-fraud rules, conduct of business rules, prospectus disclosures and other disclosures mandated as part of an offering of a complex financial product (e.g., private placement) documents. Examples include:

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[26] For instance, the customer should be informed if the intermediary or another entity belonging to the same group is the only source of liquidity for the instrument.

[27] Supra fn 16.

[28] In particular, MiFID allows investment firms to provide non-advisory services in the market without undergoing an assessment of the knowledge and experience of the customer only when certain conditions are met. Namely, these "execution-only" services are only available when the service involves so-called non-complex financial instruments and is provided at the initiative of the customer or potential customer. The customer should in any case be informed that it does have the benefit of the relevant protection. .

- assessing the level of knowledge and experience of the customer in the investment field relevant to the specific type of product or service and warn the customer that the transaction is unsuitable or that it would be prudent to take investment advice; and

- explaining in depth to the customer the nature of and specific risks associated with the transaction.

Additional possible means for client protection include:

- imposing specific requirements with respect to transactions in certain complex financial products (e.g., index warrants, currency index warrants and options), including requiring written approval to open an account to trade such products;

- requiring the intermediary to assess suitability of a service that may give access to trading complex financial products (e.g. retail trading platforms on contracts for difference, margin trading), when recommending that a customer use that service; and

- prohibiting or restricting automatically the distribution of certain categories of more risky or complex products to certain categories of customers, such as retail customers.

The regulatory system should provide for appropriate safeguards if a certain type of complex financial product may not *per se* be suitable for particular customers. At a minimum, the regulatory system should require the intermediary to collect relevant information from the customer in order to be able make a reasonable determination as to whether certain categories of transactions should be restricted or additional warnings/disclosure given for certain categories of customers, whether or not a recommendation is made.

5. Suitability protections for advisory services

Principle 5: Whenever an intermediary recommends to a customer that it purchase a particular complex financial product, including where the intermediary advises or otherwise exercises investment management discretion, the intermediary should be required to take reasonable steps to ensure that recommendations, advice or decisions to trade on behalf of such customer are based upon a reasonable assessment that the structure and risk-reward profile of the financial product is consistent with such customer's experience, knowledge, investment objectives, risk appetite and capacity for loss.

In light of the greater reliance of customers on the recommendations and advice provided, or on the exercise of investment discretion by the intermediary, the provision of such advisory or discretionary services calls for stricter protections.

The regulatory system should require intermediaries to comply with suitability obligations, calibrated to the complexity and riskiness of the product and service and the level of sophistication of the customer. For example, suitability obligations may differ depending on whether the service being offered to the customer is advisory or discretionary investment

management. Moreover, if an intermediary's behavior amounts to making a recommendation to a customer, it cannot avoid its suitability obligation by claiming that it has not made any recommendation to such customer.

Before distributing financial products, especially complex financial products, to a customer, intermediaries should gather and retain information from such customer relevant to the specific type of product or investment service. Intermediaries should have a robust process to assess the profile of a customer on the basis of its:

- investment objectives, including the length of time for which they wish to hold the investment;
- risk tolerance and relevant risk preferences, taking into account the purpose of the investment and the need for portfolio diversification;
- financial situation (e.g., assets and income) and general capacity to withstand losses; and
- investment experience and knowledge, including the nature, volume and frequency of previous transactions and level of familiarity with certain products and services. The customer's profession, former professional experience, and level of financial education may also be relevant.

Moreover, before distributing complex financial products to a customer, intermediaries should themselves develop a thorough understanding of the features of the relevant financial product and its complexity and associated risks, taking into account, when providing individual portfolio management, the composition of the customer's portfolio.

In particular, in the case of complex financial products, the intermediaries should perform their own analysis that considers:

- how the complex financial products are structured and priced;
- the nature of a product's underlying components, if any;
- the relevant level of risk (with, if appropriate, a separate assessment of counterparty, liquidity and market risks);
- the experience and reputation of the issuers and product providers;
- any fees, charges or any other costs associated with the product;
- the level of liquidity;
- the lock-in periods and relevant termination conditions; and
- the nature of any guarantees.

Special care should be given to the different components of a complex financial product in order to foster customer understanding of the risks associated with them.

Suitability obligations should apply to both the intermediary and the employees working within the firm.

In addition, when a liquid secondary market for the product does not exist, intermediaries should draw the attention of the customer to this fact and, where applicable, assess the fair value through methodologies, modelling and standards generally recognized and accepted in the market and consistent with those used by the intermediaries to value their own proprietary portfolios.

After assessing the characteristics of the customer and the product, intermediaries should determine whether the nature and risks of the product are in fact suitable to the profile of that particular customer, including whether the duration and liquidity of the proposed investment match the needs of the customer, taking into consideration his/her investment time horizon. In the case of a customer seeking products specifically for hedging purposes, intermediaries should check for consistency between the hedging needs of the customer and any products recommended.

Intermediaries must keep written evidence of the information required by the regulator to be gathered from customers as part of the suitability determination. In addition, regulators should consider requiring intermediaries to retain sufficient documentation to evidence any inquiries and analysis they made when carrying out the product and customer due diligence.

Regulators should consider providing guidance to facilitate the discharge of the suitability responsibilities in the distribution of complex financial products.

Principle 6: An intermediary should have sufficient information in order to have a reasonable basis for any recommendation, advice or exercise of investment discretion made to a customer in connection with the distribution of a complex financial product.

Before the intermediary recommends or advises a customer that it should invest in a particular financial product or purchases the product in the provision of discretionary management services to such customer, the regulatory system should require the intermediary to obtain the information necessary to make a reasonably based recommendation concerning the financial product. The goal is to reduce inducements to purchase a financial product where the customer neither understands the product, nor is capable of assuming the financial risks.

Examples of possible approaches to implement this principle include, at a minimum, that where a customer fails to provide all information requested by the intermediary, the intermediary should be required to consider whether it has sufficient information to make a reasonably based recommendation. If not, in some jurisdictions, such as in the United States and in the European Union securities sector, the intermediary would be prohibited from making the recommendation. In other jurisdictions, the intermediary would be permitted to recommend the investment, but would be required to make clear that the recommendation is based upon limited information.

In either case, the intermediary should be required to act in the best interests of the customer[29]. This means, at the minimum: (1) making reasonable efforts to obtain from the customer the information needed for a proper suitability determination; and (2) not encouraging the customer to engage in an unsuitable transaction.

[29] The words "in the best interest of the customer" should not be interpreted to suggest the application of a fiduciary standard in all instances. In some common law jurisdictions, certain intermediaries may be subject to the duty to act fairly, honestly and in good faith, while not being technically subject to a fiduciary standard of care.

Another possible means to mitigate the risk of mis-selling is to prohibit or restrict automatically the recommendation of certain categories of more risky or complex financial products to certain categories of customers, such as retail customers.

6. Compliance function and internal suitability policies and procedures

Principle 7: Intermediaries should establish a compliance function and develop appropriate internal policies and procedures that support compliance with suitability obligations, including when developing or selecting new complex financial products for customers.

In the relevant Methodology, Principle 31 of the IOSCO Objectives and Principles of Securities Regulation[30] states that "*Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters*". IOSCO has also advocated the establishment by intermediaries of a compliance function proportionate to the scale and type of their business. In particular, in a 2006 report,[31] IOSCO stated that the compliance function should be able to operate on its own initiative, without improper influence from other parts of the business, and should have access to senior management and/or, as appropriate, to the regulator.

Intermediaries should therefore be required to develop and maintain internal processes and procedures with a view to ensuring compliance with the suitability obligations, the management of conflicts of interests, the proper conduct of business and the fair treatment of all customers, including in the distribution of complex financial products. Effective internal reporting and communication of information at all relevant levels of the intermediary should be established.

More specifically, intermediaries should put in place and enforce written strategies, processes and controls that seek to ensure that any financial products they intend to distribute, especially complex financial products, are suitable for the type of customers they intend to solicit.
In particular, when developing or selecting new complex financial products for distribution, intermediaries should establish appropriate internal processes for identifying, reviewing and approving (or rejecting) the products in view to promote their compatibility with the characteristics and needs of the prospective customers they intend to target.

This includes policies and procedures that support the design of products appropriate for particular investors. For instance, products should not be designed so as to hamper intentionally the ability of targeted investors to understand the investment performance.

The compliance function should verify that the above internal processes and procedures are properly functioning.

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30 Supra fn 16.

31 See *Compliance Function at Market Intermediaries*, Final Report, Report of the Technical Committee of IOSCO, March 2006, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD214.pdf.

7. Incentives

Principle 8: Intermediaries should be required to develop and apply proper policies that seek to eliminate any incentives for staff to recommend unsuitable complex financial products.

The distribution of complex financial products by an intermediary can be more lucrative than selling *plain vanilla* securities, thus creating selling pressures and incentives to encourage unsuitable transactions. Moreover, charges associated with the purchase of complex products may often be less apparent to the investors and harder to understand.

Intermediary and staff compensation policies should be designed so that they do not encourage (and in fact discourage) the recommending of complex financial products unsuitable for the targeted customer. Senior management should be responsible for regularly reviewing incentive schemes and distribution practices by sales staff.

Regulators should consider taking steps to require disclosure of remuneration structures and policies (e.g. commissions received by the distributors from the product issuers) as a means to reduce the risks of financial incentives that could lead to unsuitable advice or recommendations.

8. Enforcement

Principle 9: Regulators and self-regulatory organizations should supervise and examine intermediaries on a regular and ongoing basis to help ensure firm compliance with suitability and other customer protection requirements relating to the distribution of complex financial products. Enforcement actions should be taken by the competent authority, as appropriate. Regulators should consider the value of making enforcement actions public in order to protect investors and enhance market integrity.

The regulatory system should provide strong and effective incentives for intermediaries to comply properly with their suitability obligations and other protection requirements, especially when they sell complex financial products to retail customers.

Regulators should intensify their efforts in supervising intermediaries to seek to ensure that such intermediaries duly comply with their obligations. To this end, on-site and off-site visits, as well as thematic reviews should be conducted to monitor that intermediaries have put in place the necessary internal processes and procedures to ensure compliance with the suitability obligations and other protection requirements. To make the most effective use of regulators' resources, intermediaries may be selected for review using risk-based methodology.

In the course of their supervisory and enforcement activity, regulators should also pay attention to the manner in which intermediaries address customer complaints and resolve any disputes with their customers. [32]

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[32] This report does not address the liability of intermediaries to their customers in cases where violations of suitability obligations or other customer protection requirements cause damages. The conditions for such civil liability may vary depending on the applicable jurisdiction. However, a regulatory system

Appendix A — Survey Outcomes

Chapter 1 — Description of suitability requirements and other customer protections

1. General regulatory framework

The IOSCO Objectives and Principles of Securities Regulation recommend that market intermediaries[33] should conduct themselves in a way that protects the interests of their clients and helps to preserve the integrity of the market. The IOSCO Principles also state that a firm should seek from its customers any information about their circumstances and investment objectives relevant to the services to be provided. Policies and procedures should be established which ensure the integrity, security, availability, reliability and thoroughness of all information, including documentation and electronically stored data, relevant to the firm's business operations. Where the activities of an intermediary extend to the giving of specific advice, it is of particular importance that the advice be given upon a proper understanding of the needs and circumstances of the customer, a concept generally reflected in the rule of conduct that the intermediary must "know your client."

IOSCO Members generally implement this standard through regulation, case laws and/or rules of self-regulatory organizations (SROs) requiring market intermediaries to comply with suitability obligations, i.e., they must assess whether the product being recommended matches the customer's financial situation and/or needs and other circumstances.

The legal source of suitability requirements may vary depending on whether a jurisdiction is a *civil* versus *common law* country. The **UK** constitutes an exception among the *common law* jurisdictions, since its current suitability rules mostly derive from primary and secondary legislation implementing the EU Directive MiFID. In the **US**, suitability arises from federal antifraud general provisions, as extended by the case law under the so-called "shingle theory" and fair dealing obligations, as well as from SROs rules and relevant interpretative guidance[34].

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that recognizes the civil liability of intermediaries to customers may provide a meaningful incentive for intermediaries to discharge properly their suitability obligations.

[33] With regard to the description of U.S. law in this appendix and accompanying report and the application of any principles to U.S intermediaries, the term "intermediary" includes registered broker-dealers only.

[34] The survey answers reflected in this Appendix, when referring to the US, generally, refers only to the US SEC whenever the information concerns a range of financial products broader than those complex financial products that fall within the scope of the CFTC's oversight. However, in the Report itself, the term "US" can apply to both the SEC and CFTC because the Report and its principles are applicable only to complex financial products. Particular answers relating to the CFTC's supervision of complex products which are included in this Annex are identified as the CFTC response. Furthermore, it should be noted that in the US, all broker-dealers must be members of FINRA in order to do business with the public (retail and institutional). FINRA is the successor organization to another US SRO, the NASD. FINRA continues to issue guidance to the industry and to investors regarding structured and other complex products. FINRA published Regulatory Notices addressing *Sales Practice Obligations for Commodity Futures-Linked Securities and Sales Practice Obligations with Reverse Exchangeable Securities* (Reverse Convertibles). In addition, FINRA has developed online training regarding structured products and frequently hosted or participated in discussions of new and complex product issues at industry events, including FINRA's Annual Conference. FINRA has also provided educational resources to investors regarding complex and/or risky products as in its recent podcast

Legal interpretations supplementing regulatory requirements have been issued by members from Australia (**AU**)[35], France (**FR**), Italy (**IT**)[36], Singapore (**SG**)[37], Spain (**ES**)[38], the **UK** and Switzerland (**CH**). Industry "best practices" also play a significant role in several member jurisdictions, as in Canada (**CA**) [39], Brazil (**BR**), **CH[40]** and the **UK.**

Suitability rules usually require market intermediaries to: (i) obtain adequate information on the investment products they are selling, and (ii) assess the customers' specific financial situation, needs and other circumstances; the intermediary should have a reasonable basis for believing that the customer is able to *understand the risk-reward profile* of the investment and/or that the specific financial product meets the customer's *financial capabilities* and *investment objectives.*

The suitability assessment may vary depending on the type of service provided and the customer's level of sophistication. In this latter respect, it is usually assumed that a non-retail client has the necessary experience and knowledge to purchase the particular securities and – except in the **EU** for the service of individual portfolio management - that he is financially able to bear investment risks consistent with his investment objectives.

The suitability assessment is not required, or is less demanding when no recommendation, advice or discretionary portfolio management is being provided. For instance, in the **EU**, where a recommendation (or advice) is given, MiFID suitability rules provide that the investment firm shall obtain and evaluate information regarding the client's or potential client's:

i). knowledge and experience;

ii). (ii) financial situation; and

iii). investment objectives and risk appetite.

This suitability assessment is broader than the *appropriateness* assessment required in connection to non-advisory services. In particular, according to the *appropriateness* requirement, when providing non-advisory/non-discretionary services, the investment firm has to ask the client or the potential client to provide information on his knowledge and experience in the investment field relevant to the specific type of product or service offered

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(Oct. 2011) on Structured Notes with Principal Protection available at http://www.finra.org/Investors/SmartInvesting/GettingStarted/Podcasts/Bonds/P124750..

35 See ASIC regulatory guides available at http://www.asic.gov.au/asic/asic.nsf/byheadline/Regulatory+guides?openDocument.

36 Consob Communication no. 9019104 of March 2, 2009.

37 Singapore Financial Advisers Act ["FAA"], Notice on Recommendations on Investment Products, and Singapore Securities and Futures Act Notice on the Sale of Investment Products.

38 CNMV guidance of June 17th, 2010.

39 Securities Acts of all provinces and territories, National Instrment 31-103 and Investment Industry Regulatory Organization of Canada (IIROC) Rules.

40 Code of Conduct for Securities Dealers http://www.swissbanking.org/en/801908_e.pdf and Codes of Conduct of the Swiss Funds Association https://www.sfa.ch/self-regulation/codes-of-conduct?lang=en

or demanded. In case the investment firm considers, on the basis of the information received, that the product or service is not appropriate to the client or potential client, the investment firm shall warn the client or potential client[41].

Suitability requirements vary from jurisdiction to jurisdiction. In particular, the survey of SC3 Members' current regulatory frameworks revealed a significant range of differences, for example:

- the scope of application, especially when it comes to the definition, if any, of sophisticated investors;
- the steps to be complied with and the relevant factors embedded in the suitability determination;
- the internal controls and organizational requirements that the market intermediary is required to put in place in order to help ensure compliance with suitability requirements;
- the consequences arising when the market intermediary assesses that the product is unsuitable to the client; and
- enforcement regimes.

Furthermore, in relation to complex financial products, some IOSCO members provide for the application of the general domestic suitability rule requirements, whilst others have developed more detailed regulation or interpretative measures geared towards such products in order to help ensure that their features and particular risks they pose are duly considered[42]. For instance, with respect to the **US SEC**, in relation to certain types of transactions in index warrants, currency index warrants, and currency warrants, options and securities futures, the competent authority requires specific approval or disapproval in writing for such trading in the customer's account[43]. The rules applicable to the CFTC with respect to complex products are described in Chapter 3 of this Appendix. In **IT**, the regulator developed specific guidance with respect to the distribution of illiquid financial products.

In the **EU**, the non-complex nature of the product is one of the conditions that permits an

41 Except for certain circumstances where MiFID allows investment firms to provide investors with a means to buy and sell certain financial instruments in the market without undergoing any assessment against knowledge and experience of the investor. These "execution-only" services are only available when certain conditions are fulfilled, namely when it involves so-called non-complex financial instruments.

42 This is the case in **IT** and **US** where Consob and FINRA developed specific guidance with respect to the distribution of certain complex financial products. Consob has also formally validated the best practice guidelines developed by the industry for the concrete implementation of the suitability requirements in connection with illiquid financial products (this means that any conduct in line with this guidance will be considered compliant with Italian law).

43 FINRA Rule 2360(b)(16)(B) (requiring the approval of all options accounts in writing when they are opened), and FINRA Rule 2352 (requiring that all purchases or sales of index warrants, currency warrants, and currency index warrants be subject to the same approval rules for options set forth in FINRA Rule 2360(b)(16)).

intermediary to provide non advisory/discretionary services without assessing the appropriateness of a given product (i.e., on an *execution-only* basis).

Some regulators have raised the issue of a so-called "level playing field" across different types of products having similar economic functions. If the regulation does not require the application of similar standards to substantially similar or substitute products, distributors may tend to prefer the sale of less regulated products in order to cut the costs arising from the application of more stringent rules. In order to address this risk, in **IT** the marketing and selling rules applicable to financial instruments have been extended to the sale of financial products issued by banks and insurance companies. Moreover, in the **UK,** MiFID-based suitability requirements also apply to advice involving life insurance policies with an investment element (as opposed to 'pure protection' insurance).

The following sections consider in more detail the similarities and differences of approaches on the suitability requirements applicable in the distribution of complex financial products among the IOSCO members who responded to the survey. This Appendix highlights possible trends and potential regulatory gaps and relevant risks, with a view to encouraging convergence in regulatory approaches among IOSCO members.

2. Scope of application

2.1 Type of financial service

In the vast majority of members' jurisdictions[44], suitability requirements differ depending on the type of investment service being provided.

A full suitability assessment is usually required whenever an intermediary provides advisory services, including portfolio management, recommendation or investment advice[45]. This means that prior to giving any recommendation/solicitation/personal investment advice to a client, or otherwise exercising investment discretion on behalf of a client, the intermediary must verify that the transaction is suitable to the client taking into account his investment portfolio, financial circumstances and needs.

The rationale underlying suitability obligations is that the intermediary should bear a special responsibility where it seeks to advise a client to make a particular investment. In general, research has shown that clients will in most circumstances simply follow any

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[44] All except **JP**, where no distinction with respect to suitability requirements is made on the basis of the type of service provided by the intermediary. In **JP** the suitability requirements apply where an intermediary conducts solicitation vis-à-vis retail investors, however the regulation for solicitation focused on relatively risky contracts, such as derivative transactions.

[45] There are differences, however, regarding the precise definition of the scope of suitability requirements across jurisdictions. In the **EU**, as mentioned, full suitability requirements apply in relation to portfolio management and investment advice, as opposed to the other services, for which an intermediary is allowed to apply a narrower "appropriateness test". In **CA**, suitability requirements apply to full-service brokers; in **SG**, **US**, a suitability determination is necessary when making a recommendation to a customer, in **AU** when a personal advice is provided in relation to financial products, in **MX** prior to any recommendation or advice, in **HK** when the intermediary makes a recommendation or solicitation. In **CH** where supervised or regulated intermediaries are advising clients, there are civil obligations (even for non-supervised) similar to those mentioned for discretionary asset management implied by an advisory agreement or by the creation of a trust liability.

advice/recommendation given to them by their intermediary[46]. This justifies special protection, particularly for retail investors (who may not have adequate knowledge and experience to evaluate adequately the suitability of the product consistent with his/her investment goals and financial situation). This is particularly important as the intermediary could exploit the information asymmetries and take advantage of its position to the detriment of the client.

Suitability obligations (if any) in connection with non-advisory services vary significantly from members to members. The most widespread approach is that there are no suitability obligations if no recommendation or advice is made (as in **MX**, **CH**, **US**); in some cases the requirements are narrower than a full suitability assessment (as in the **EU** and **SG**).

In **SG**, intermediaries are required to assess a customer's investment knowledge and experience before the customer can purchase complex investment products, and in the case of complex exchange-traded products, before the customer can open an account to trade such products.

In the **EU**, when the intermediary does not provide investment advice or portfolio management, the so-called appropriateness requirements apply. As mentioned, these requirements are narrower than the suitability requirements, since the intermediary has to assess the knowledge and experience of the client with respect to the particular asset or service, but not the financial situation and investment objectives of the client. If the intermediary provides execution-only services (i.e., it only executes, or receives and transmits orders on certain non-complex products[47] at the investor's request, without providing advice or discretionary management), then no suitability/appropriateness requirements apply at all. The intermediary is required, however, to warn the customer that he/she does not benefit from any suitability/appropriateness related protection.

In **CA,** full-service brokers are required to ensure that the products sold to clients are suitable for them with some exceptions (e.g., institutional clients), whilst discount brokers (non-advice platforms and brokers acting on an execution-only basis), and divisions of full service brokers granted with a suitability exemption are not subject to suitability requirements[48].

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46 See Appendix 2 at 8 FR01/11 *Principles on Point of Sale Disclosure*, Final Report, Report of the Technical of IOSCO, ,February 2011, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD343.pdf.

47 The definition of non complex products includes shares admitted to trading on a regulated market or in an equivalent third country market, money market instruments, bonds or other forms of securitized debt (excluding those bonds or securitized debt that embed a derivative), UCITS and other non-derivative financial instruments satisfying certain requirements such as a high level of liquidity, lack of leverage and availability of public information.

48 More in details, a dealer (IIROC member) that has applied for and received approval from IIROC (Rule 3200) is not required to comply with the suitability determination when accepting orders from a customer where no recommendation is provided. This approval may be granted to: (i) a dealer offering solely an order-execution service, either as the dealer's only business or through a separate business unit of the dealer , or (ii) a dealer offering both an advisory and an order-execution only service. It is important to note that there is no relief pertaining to the dealer's gatekeeper responsibilities with respect to potential fraud (i.e.: stock manipulation, insider trading, front running, etc.).

2.2 Type of the investor and level of sophistication

As described in more detail below, the definition or understanding of a *wholesale*, *professional* or *institutional* investor, and the consequences of such terms, varies significantly across jurisdictions (we refer hereafter to these terms collectively as *non-retail investors*). These definitional variations are material because in some jurisdictions, suitability (or appropriateness) requirements may not apply (in whole or in part) to such clients[49], or to a narrower category of non-retail investors[50], on the assumption that their presumed level of expertise and financial sophistication or professionalism justifies an exemption from the protection afforded by the suitability rules[51]. On the other hand, in the **US**, the fact that a customer is considered *institutional* is simply used as *guidance* on how an intermediary may meet its customer specific suitability obligations under FINRA Rule 2310(a), which is generally applicable to all customers.

Most jurisdictions have regulations stating that all regulated/licensed entities are non-retail investors and, as such, trigger the exemption[52]. In the **EU**, for instance, these institutions are qualified as *per se professional clients* triggering exemptions, in contrast to other non-retail investors who must apply to the intermediary in order to be treated (subject to certain conditions) as non-retail.

The main differences among the surveyed jurisdictions rest on the treatment of:

- corporate entities, other than licensed entities;
- natural persons and, more specifically, wealthy individuals.

Large corporate entities are often treated as non-retail investors. This is the case, for instance, when they trigger the definition of *large undertakings*,[53] or because the corporation

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49 This is the case in **AU, HK, JP, SG**.

50 In **CA** the suitability determination is required for so called permitted clients, unless they waived the firm's obligation in writing. Suitability determination is also required for all retail clients, professionals (non clients) (i.e., individuals acting as representatives for a broker\dealer) and - to a certain extent - institutional clients (suitability determination is required for institutional clients unless the dealer determined that the client is sophisticated enough and is able to make its own investment decisions). In **EU** (**DE, ES, FR, IT, NL** and **UK**) no appropriateness test applies to so called "eligible counterparties" (i.e.: certain categories of clients that agree to be treated as eligible counterparties), whilst a partial suitability test applies to professional clients.

51 In **CH**, conversely, all customers shall be subject to the suitability rules, including qualified investors. In **HK** the suitability test applies to all customers, but such requirement may be waived by professional investors. In **SG**, suitability requirements under the Financial Advisers Act ["FAA"] are intended to accord protection to retail investors; exemptions from such requirements are provided under the FAA for intermediaries dealing with accredited investors who are able to safeguard their own interests.

52 All jurisdictions except **US**. In **CA**, however, dealers have still to determine the level of sophistication of certain regulated entities (and more generally of institutional clients) in order to determine the extent of suitability owned to those clients.

53 In the **EU**, larger undertakings to be considered as professional clients shall must meet two of the following three criteria: total balance sheet of €20,000,000; net turnover of € 40,000,000 and own funds of € 2,000,000. In the **US**, the FINRA suitability rule defines an institutional customer, for purposes of that rule, as an entity that is not a natural person and that has at least $10 million invested in securities in the aggregate in its portfolio and/or under management. *See* IM 2310-3, Suitability Obligations to Institutional Customers, available at:

has applied for a waiver by representing in writing its financial expertise and wealth and/or it has otherwise given reasonable evidence of such expertise and/or wealth.[54]

In determining whether a customer is a non-retail investor, the majority of respondents set forth thresholds on financial resources for individuals, although these thresholds vary from country to country.[55] When the threshold is met, the person is automatically considered, or is eligible to be considered, a non-retail investor. Generally, the client has to sign a written statement in order to be treated as a non-retail investor. In **AU**, the qualification of a client as retail depends on the nature of the client, and also on the type of financial product the advice relates to.

Another difference in approaches is in the mechanisms for the granting waivers or applying exemptions. In particular, in some jurisdictions the intermediary is entitled to rely on a written waiver by the client, whilst in other systems the responsibility to verify whether or not the exemption is met rests on the intermediary. For instance, in the **EU**, the waiver made by a customer (other than a professional investor) shall be considered valid only if an adequate assessment by the investment firm of the expertise, experience and knowledge of the client, gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and of understanding the risks. In **AU**, where 'personal advice' is given, the intermediaries must make reasonable inquiries about whether the information already held about the client's relevant personal circumstances is up-to-date and complete; this obligation cannot be avoided by disclaimers to the client.

Moreover, the scope of local waivers, where available, varies to a significant extent In some countries, the suitability obligation is *per se* not applicable to non-retail clients; in others, the requirement may be different for certain non-retail investors so that, e.g., *customer specific* suitability obligations can be *waived*. For example, in the **US**, on July 9, 2012, FINRA Rule 2111 will replace the current **US** suitability standards found in NASD IM-2310-3[56]. The new rule for institutional investors focus on whether there is a reasonable basis for broker-dealer intermediaries to believe that the customer can independently evaluate investment risks, both independently and with regard to investment strategies, and that the customer is exercising independent judgment in evaluating recommendations[57]. The rule also requires that the institutional investor affirmatively indicate that they are exercising independent judgment[58].

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http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3641. In July 2012, FINRA Rule 2111(b) will replace the NASD Suitability Obligations to Institutional Customers. The new rule will define institutional customers using NASD Rule 3110(c)(4), which defines institutional customers based on their operations, or by possession of total assets over $50 million.

[54] This is the case in **CA**, **MX**, and in **EU** (i.e.: **DE**, **ES**, **FR**, **IT**, **NL** and **UK**) only for undertakings not triggering the size of the large undertakings (see previous footnote). In **AU** a client is not a retail if the financial product or service is provided for use in connection with a business which is not a small business.

[55] This is the case in **AU**, **CA**, **DE**, **ES**, **HK**, **JP**, **FR**, **IT**, **MX**, **NL**, **SG**, and **UK**. In the **US** firms may use the institutional suitability exception after July 2012 to recommend securities to individuals with assets in excess of $50 million.

[56] FINRA Regulatory Notice 11-25 (May 2011).

[57] The rule also harmonizes the definition of institutional customer for suitability with the more common definition found in NASD Rule 3110(c)(4). Exchange Act Release No. 62718A (Aug. 20, 2010).

[58] Id..

This provision only allows the investor to waive its customer specific obligations; broker-dealers must still meet the reasonable basis and quantitative suitability requirements even if there has been a waiver by the customer[59].

In addition, FINRA rules provide that a member determines the scope of its suitability obligations in relation to an institutional customer on the basis of a set of factors, such as (i) the customer's capability to evaluate investment risk independently[60] and (ii) the extent to which the customer is exercising independent judgment in evaluating the member's recommendation[61]. Generally, a member fulfills its suitability obligation to determine that a recommendation is suitable for an institutional customer if the member has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk.

In some countries the client qualified as non-retail investor may nonetheless request the application of the ordinary suitability regime. This is the case, for instance, in the **BR, CA**, **EU** and **JP**, where certain non-retail investors may opt-out of that classification and be treated as retail clients for the purpose of the suitability assessment. The qualification of a client as a non-retail client is usually based on objective factors. Examples of objective criteria are the nature of the customer (e.g., regulated vs. unregulated entity; person acting in its business vs. consumer), his financial status (triggering or not triggering certain financial thresholds), his previous financial experience (e.g., frequency and size of previous investments, professional experience in the financial sector) and his request for a waiver.

However, whilst in some jurisdictions intermediaries may heavily rely on the client's choice of classification, in other countries the intermediary is required to make its own assessment on the validity of the waiver[62]. The rationale behind this approach is to give responsibility to the intermediary, thus in theory diminishing the risk of mis-selling.

2.3 Distribution channel

In general, suitability requirements do not differ depending on the means or channel utilized

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59 FINRA Regulatory Notice 11-02 (Jan. 2011).

60 Relevant factors are: (1) the use of one or more consultants, investment advisers or bank trust departments; (2) the general level of experience of the institutional customer in financial markets and specific experience with the type of instruments under consideration; (3) the customer's ability to understand the economic features of the security involved; (4) the customer's ability to independently evaluate how market developments would affect the security; and (5) the complexity of the security or securities involved. NASD IM 2310-3.

61 Relevant factors are: (1) any written or oral understanding that exists between the member and the customer regarding the nature of their relationship and the services the member renders; (2) the presence or absence of a pattern of acceptance of the member's recommendations; (3) the use by the customer of ideas, suggestions, market views and information obtained from other members or market professionals, particularly those relating to the same type of securities; and (4) the extent to which the member has received from the customer current comprehensive portfolio information in connection with discussing recommended transactions or has not been provided important information regarding its portfolio or investment objectives (NASD IM-2310-3).

62 In the **US** an institutional client must take an affirmative action to indicate that it is exercising independent judgment in order for its broker-dealer to apply the suitability requirements for institutional investors. The broker must also have a reasonable basis for believing that the institutional client is capable of independently evaluating the investment. See FINRA Rule 2111(b).

to distribute investment products. However, the use of the Internet may pose unique issues. Indeed, several SC3 members have issued guidance on how to apply and/or adapt the general suitability regime to the case of web-based interactions.

For instance, in **CA,** guidelines are set out on the supervision of electronic communications. The notice included guidance on the use of a personal home computer for business-related emails, approval of electronic communications sent to clients, acceptance of orders sent via emails, etc. In the **US**, FINRA provides guidance on what communications over the Internet could be considered recommendations triggering the application of suitability requirements.[63]

3. Suitability assessment

3.1 Steps to classify investors and products

Generally, the aim of the investor and product classification is to determine which conduct of business and other regulatory requirements should be applied, including solicitation during the distribution of specific types of financial products.

Intermediaries are usually required to gather information on the one hand from the client on its relevant personal and financial circumstances and investment objectives, and on the other hand on the type of products envisaged to be distributed. The financial product is generally assessed on the basis of its own characteristics and of external factors that may impact on the riskiness of the product[64]. Depending on the circumstances, the intermediary may rely on product information supplied by external research houses, although it is typically required to take reasonable steps to ensure that the research is accurate, complete, reliable and current. [65]

The purpose of the product due diligence process is so that intermediaries develop a thorough understanding of the structure of the investment products. In some member jurisdiction, this means that the intermediary must consider, for instance, how the complex product is structured and priced, the nature of the underlying investments, the relevant level of risks, the experience and reputation of the issuers and service providers, the fee and charges, the performance, the level of liquidity, the lock-in periods and termination conditions[66].

Certain regulatory systems, however, focus more on the client side, without providing specific standards for carrying out product due diligence.

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63 FINRA Regulatory Notice 11-02 (Jan. 2011); NASD Notice to Members 01-23 (April 2001).

64 This is the case in **ES, HK, IT, SG**. **HK** provided examples of external factors, e.g.: market and industry risks, economic and political environments, regulatory restrictions.

65 In **AU**, the relevant regulator, ASIC, has supplemented legal requirements with regulatory guidance to this effect: Regulatory Guide 175 *Licensing: Financial product advisers — conduct and disclosure* (RG 175)

66 These elements are to be considered, for instance, in **HK** and **IT**. In the **US**, a broker-dealer has a general obligation to investigate and have adequate information about any security it is selling. In addition, when analyzing a structured product to determine if it meets the so-call “reasonable basis suitability test,” FINRA members need to consider whether the instrument is priced such that the potential yield is appropriate in relation to the volatility of the basket of securities, index, commodity, debt issuance, and/or foreign currency on which the structured product is derived (“reference asset”) compared to other investments that are similar in terms of structure, volatility, and risk. See NASD Notice to Members 05-59 (Sept. 2005).

Once an intermediary collects the required information, it must generally analyze it for the purpose of determining the investor's profile and identifying suitable financial products. Investors are usually classified on the basis of their investment objectives, risk tolerance, financial situation/profession and investment experience[67]. In most of the respondent jurisdictions, regulations specify the type of information that should be collected from the client (see next paragraph).

Several member jurisdictions require that the intermediary's collection of information be fully documented and that customer information be updated on a periodic basis. (see par. C.4 below). In most SC3 member jurisdictions, there are no special rules for complex products.

The type of customer and product due diligence that intermediaries have to carry out is based on the same general standards applicable to any other securities. Several members observed that, as a matter of practice, where a product is more complex, the suitability assessment will be more exhaustive, particularly with regard to product due diligence and the information collected from the customer.[68] In the **US**, some complex products have specific guidelines and factors that must also be taken into account in addition to the general suitability standards[69].

3.2 Information collected from investors

In relation to advisory services, in all jurisdictions, intermediaries are required to collect information from clients with regard to their investment objectives, financial situation, risk appetite and relevant experience and knowledge. Nonetheless, the type of information to be gathered may depend on the nature of the client (non-retail vs. retail) and service provided (advisory vs. non-advisory).

For instance, in the **EU**, when providing investment advice or portfolio management, the intermediary must obtain information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives. When providing investment services other than investment advice and portfolio management, intermediaries collect only information regarding the client's knowledge and experience in the investment field relevant to the specific type of product or service offered or requested.

Although the details vary to a certain extent from jurisdiction to jurisdiction, the broad range and type of information to be collected from investors have a great deal in common. Generally, information collected by intermediaries on the client's investment objectives includes:

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[67] These factors have been mentioned by AU, BR, CA, DE, ES, FR, HK, JP, MX , SG, CH, UK.

[68] In this sense, **AU**.

[69] For example, FINRA Rule 2360(b)(19)(B) requires that the purchaser of an options contract must be able to bear the risks of the option contract in addition to general suitability standards regarding the characteristics of the investor. FINRA has also issued special guidelines for products such as leveraged and inverse exchange-traded funds (ETFs) that set out particular risks that should be evaluated by any firm recommending the transaction. See FINRA Regulatory Notice 9-31 (June 2009).

i). the expected holding period of the investment;

ii). preferences regarding risk taking;

iii). his/her risk profile/tolerance; and

iv). the purposes of the investment;

Information regarding the client's knowledge and experience usually includes:

i). the types of service, transaction and designated investment with which the client is familiar;

ii). the nature, volume, frequency of the client's transactions in designated investments and the period over which they have been carried out; and

iii). the level of education, profession or relevant former profession of the client.

A client's wealth is generally assessed by examining his/her regular income, tax paid, and assets. In the **EU**, intermediaries may rely on the information provided by their clients or potential clients, unless they are aware or ought to be aware that the information is manifestly out of date, inaccurate or incomplete.

3.3 Recordkeeping

Recordkeeping requirements specifically relating to suitability apply in most member jurisdictions[70]. Required records may include documentation received from customers regarding their financial knowledge and experience, financial situation, investment objectives and risk appetite. They must also maintain records of relevant waivers or requests to be treated as professional clients (in those jurisdictions where customers are permitted to *waive* regulatory protections)

For instance, depending on the jurisdiction, an intermediary may be required to keep the following records:

- inquiries made about the client's personal information, the consideration and investigation of the subject matter of the advice, including reasons why the advice was considered to be suitable or 'appropriate'[71];

- the information given to each client and the rationale for recommendations given to each client (including any material queries raised by the client and the responses given by the intermediary), all client transactions (including orders placed to product providers) and records that are sufficient to explain and reflect the financial position

[70] In **JP,** records required to be kept are used for broader purposes, including suitability determination. In addition, in the **US**, broker-dealers are not specifically required to document *how* they arrived at a suitability determination.

[71] In **AU**.

and operation of their business[72];

- all sales documents, including information gathered from the client, any recommendation made to the client by the representative and the basis for the recommendation [73];

- all communications received and copies of all communications sent by the broker-dealer relating to its business as such[74].

Records must usually be maintained for at least 5 years[75], although the range varies from 1[76] to 7 years of the date that personal advice is provided to a retail client[77] or of the day that an account is closed.[78]

In addition to recordkeeping obligations, intermediaries are usually required to provide to the customer the documents giving evidence of the executed transactions and/or of the reasons for the advice. For example, respondents mentioned the following documents:

- a *statement of advice* which discloses the advice and the basis for the advice and includes as much detail about a matter as a person would reasonably require for the purpose of making a decision about whether to act on the advice as a retail client[79];

- trade confirmations and account statements which can be sent in paper form (by the mail) or delivered electronically[80];

- information on the financial instruments purchased and, when providing individual portfolio management, a list of the types of financial instruments which may be purchased for the customer as well as a description of the investment objectives for the individual portfolio management[81];

- minutes of the meeting between customer and intermediary (telephone meetings included) which reflect the relevant content (e.g. the minutes must list all the

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72 In **HK**.

73 In **SG.**

74 In **US**.

75 In BR, FR, DE, ES, IT, MX, SG, UK.

76 In **NL**.

77 In **AU** and **HK**.

78 In **CA**. In the **US**, the recordkeeping requirement for the information collected from the client is 6 years after the earlier of the date the account was closed or the date on which the information was replaced or updated. In UK intermediaries performing advised business in relation to certain (specified) pensions contracts shall keep records indefinitely.

79 In **AU**.

80 In **CA**.

81 In **EU**.

recommendations the intermediary provides, all information provided by the customer and the relevant factors which determine the suitable products for this customer)[82];for certain specified types of *packaged* retail investment product, a written summary of the investment advice given and the reasons for the recommendation (suitability report) which must, at least, specify the client's demands and needs and explain why the firm has concluded that the recommended transaction is suitable for the client, having regard to the information provided by the client and any possible disadvantages of the transaction for the client[83];

- prospectuses or offering circulars and other documents relevant to the investments, as well as a copy of the rationale for the investment recommendations, explanations of why the recommended investment products are suitable for the client and the nature and extent of risks the investment products bear[84];

- prior explanation in a manner and to the extent necessary for ensuring that the customer understands such matters, in light of the customer's knowledge, experience, the status of his/her properties and in light of the purpose of concluding the contract for financial instruments transaction as well as, prior to conclusion of a contract, a document which explains the outline of the relevant contract and the matters concerning fees, remuneration or any other consideration payable by the customer etc.[85];

- copy of the information collected, so that the customer can verify the accuracy of the data and, if necessary, contact the broker-dealer to correct the information[86];

- for non-advised business, where required, a warning (which may be in a standardized format) to a client that the firm does not regard the proposed transaction appropriate for the client.[87]

In **IT**, Consob issued guidance requesting that intermediaries provide clients with unbundled information on the price of the complex product which distinguishes the fair value (with separate indication of the fair value of any derivative component) from the costs, including the distributor's fees. Intermediaries should also assess and inform the clients of the divestment value of the product (assuming market conditions remain unchanged) and methods of selling illiquid products. Intermediaries should also provide comparison of the risk/return of illiquid products with substitute liquid products and present performance scenarios based on objective simulation analysis. Information on the fair value and presumable disinvestment value of the product shall be given to the investors on a periodic

[82] In **DE**.

[83] In **UK.** In **NL** the intermediary must, where it concerns advice regarding financial products other than financial instruments, explain the considerations underlying its advice insofar as this is necessary for a proper understanding of the advice. There are no standard documents that are required, however most intermediaries provide a summary of their advice.

[84] In **SG** and **HK**.

[85] In **JP**.

[86] In **US**.

[87] In **EU** and **BR**.

basis.

3.4 Timing

In all jurisdictions, it is expressly required that the suitability determination is made before the intermediary provides the relevant investment service (e.g. before any advice/recommendation/offer is presented to the client and before the execution of the transaction).

Where the suitability determination is made in connection with portfolio management, the requirement usually applies on an ongoing basis, i.e.: anytime the intermediary exercises investment discretion on behalf of a client[88].

In the **US**, specific requirements apply to index warrants, currency index warrants, currency warrants,[89] options and securities futures, where the broker-dealer must approve the customer for such trading before opening an account[90]. In addition, prior to allowing purchases of structured products, broker-dealers should approve the customer for options trading or have comparable procedures for ensuring that structured products are only sold to persons for whom the risk is appropriate[91].

3.5 Elements for the determination

As discussed above, intermediaries making a suitability determination are required to match the risk return profile of each recommended investment product with each client's personal circumstances by using their professional judgment and diligence. The purpose of this requirement is to ensure that the specific investment is in the best interests of the client[92], taking into account the client's investment objectives, investment horizon, risk tolerance, and financial circumstances.

Factors considered by regulators include the knowledge and experience of the client his/her financial situation, investment objectives and risk appetite. Examples of the former are the trading history of the client (including frequency of investment) and his/her level of education and profession. Examples of the latter are length of time the client wishes to hold the investments, his/her preference for risk taking, his/her risk profile, and the purpose of the investment.

In making a suitability determination, the above factors are not applied rigidly: suitability requirements in member jurisdictions do not involve prescriptive and specific criteria for matching particular product features or types of products to client types. Rather, the standards usually contemplate a range of factors that an intermediary should consider, as necessary and

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88 In FR, DE, ES, IT, NL, CH and UK.

89 FINRA Rule 2352.

90 FINRA Rule 2360(b)(16)(B).

91 See NASD Notice to Members 05-59 (Sept. 2005).

92 In AU advice must only be "appropriate to the client" given the relevant considerations. Legislation imposing a "best interest duty" is currently being considered.

relevant to the specific situation..

In some respondents' jurisdictions, the elements for the suitability determination are set forth in non-mandatory regulatory or industry guidance.[93] In other jurisdictions, the relevant provisions entail mandatory application of a set of factors that intermediaries are required to take into account (although their application shall be reasonably adapted to the case)[94].

Most members applying a, suitability determination with respect to complex products require intermediaries to consider:

- the level of liquidity against the investor's sophistication and expected holding period;

- the up-front costs against expected holding period; and

- in the case of a product sold for hedging purposes, bona fide hedging needs by the customer[95].

In addition to the above, some respondents mentioned the following types of risks and products characteristics to be part of the suitability assessment of complex products:

- taxation implication associated with investing in complex products;
- with respect to over the counter (OTC) derivatives, the existence or not of loss limitation;
- product's market and credit risks;
- concentration of the securities in the customer's portfolio;
- upfront costs;
- conflict of interest between client and the advisor;
- high risk trading strategies;
- volatility;
- effects from the derivative embedded (or from any component of) in a complex product;
- transaction costs;
- effect of gearing;
- foreign currency risks; and
- the amount and type of information readily available to clients about the product.

3.6 Generally unsuitable products

Generally, the regulatory regime does not designate particular complex financial products as being *per se* unsuitable for a particular category of clients. The regulatory approach of members is, rather, to place the onus to assess the suitability on intermediaries, having regard to the complexity of the products and the particular circumstances of the clients, on the grounds that intermediaries are better placed to carry out this activity and suitability

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93 This is the case of **MX**.

94 Specific mandatory factors have been mentioned by **CA, EU** countries (**DE, ES, FR, IT, NL, UK**), **HK, JP, SG** and **US**.

95 This is the case in AU, CA, DE, ES, FR, IT, JP, CH, UK.

assessment can be better done on an individual, customer-by-customer basis.

Nonetheless, in certain jurisdiction complex products may deserve special treatment. For instance, in **EU** the lighter regime applicable to execution-only services does not apply to complex financial products (this means that the appropriateness test must always be satisfied for complex products).

In **FR**, some CIS and structured debt securities are considered to be highly complex and accordingly unsuitable for marketing to retail clients.

In the **US,** products such as options, index warrants, currency index warrants, and currency warrants are presumed unsuitable for any customer, but the presumption can be rebutted when there is a reasonable basis to believe that the individual is capable of handling the instrument[96].

In **BR** the distribution of some high risk investments funds is limited to qualified investors and in the **DE, FR, IT** and **UK** there are restrictions on the marketing of unregulated (or less regulated) collective investment schemes, including hedge funds, to retail clients.

In **HK** intermediaries should exercise extra care in advising elderly or unsophisticated clients or those who may not be able to make independent investment decisions on complex investment products and rely on the intermediaries for advice. When the intermediary provides services in derivative products, it should assure itself that the client understands the nature and risks of the products and has sufficient net worth to assume risks and bear the potential losses of trading in the products.

In **JP**, an intermediary may not solicit an individual customer who has not requested solicitation to enter into an OTC derivative transaction. In addition, an intermediary may not solicit a customer who is not a professional investor to enter into an OTC derivative and particular exchange traded market derivative transaction without obtaining a confirmation from the customer, prior to solicitation, whether he/she wishes to receive such solicitations.

4. Internal controls

4.1 General organizational requirements (q. 13)

In most jurisdictions, intermediaries are required to comply with the general internal organization requirements (as described below) when they apply suitability rules[97]. These internal organization related requirements are aimed at ensuring that the intermediary appropriately carries out the suitability determination, in accordance with the applicable rules.

Depending on the national regime, intermediaries shall, for instance, ensure that they:

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96 FINRA Rules 2353 and 2360(b)(19)(A). Another example of products that are deemed to be generally unsuitable for retail investors are inverse and leveraged ETFs if they are to be held for more than one trading session. FINRA Regulatory Notice 09-31 (June 2009).

97 This is the case in CA, DE, ES, FR, HK, IT, MX, NL, CH, SG, UK.

- have put in place adequate governance and organization arrangements and written internal policies and procedures, including those designed to minimize the risk of failure;
- have available adequate resources (including financial, technological and human resources) to provide the financial services;
- have an effective compliance function (or supervisory personnel) and have established, implemented and maintained adequate policies and procedures reasonably designed to achieve compliance with applicable rules;
- recruited staff who are fit and proper and have an adequate level of knowledge and skills to provide advice to clients and provide regular and appropriate training to the staff and its representatives;
- have a dispute resolution system or complaints handling processes where financial services are provided to retail clients;
- have adequate risk management systems; and
- has adequate systems and controls to promptly identify issues and matters that may be detrimental to a client's interests.

In **BR**, according to CVM new proposed rule, twice a year the officer in charge of the compliance with suitability requirements must submit a report to the board of directors of the intermediary, addressing the adequacy of the suitability rules, procedures and internal controls. The report must also include recommendations for improving any deficiencies.

In **SG**, senior management approval is required before an intermediary may open a customer account for complex exchange-traded products. The senior management should ensure the necessary suitability assessment has been conducted before giving this approval.

In **US**, in addition to the general rules on supervisory and compliance internal systems, there are strengthened requirements compared to the general ones for certain complex financial products. For example, broker-dealers effecting options transactions must maintain written procedures for the conduct of business, including, among others, suitability criteria and standards.[98] As part of account opening procedures for index warrants, currency index warrants and currency warrants, options, and securities futures trading, a branch office manager or other principal must specifically approve or disapprove in writing a customer's ability to engage in such trades for the customer's account. The broker-dealer must keep records of the approval or disapproval. Also, with regard to structured products, members are required to train supervisory and registered persons regarding the characteristics, risks, rewards, and suitability of each structured product before they allow sales of these products to investors. Members should also consider the best practices for vetting new products, involving compliance and legal personnel in the initial product assessment and supervisory personnel in the product review process. For non-conventional investments, FINRA requires that its members establish internal controls, including supervision and training requirements, that are reasonably designed to ensure that sales of non-conventional investments comply with all applicable NASD and SEC rules, including requiring that associated persons perform appropriate customer-specific suitability[99].

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98 See, e.g., CBOE Rules 9.8 (Supervision of Accounts), 9.10(a) (Supervision of Discretionary Accounts), and CBOE Rule 9.7(f) (Opening of Accounts).

99 FINRA has similar requirements for sales of hedge funds: a member's internal controls, including supervision and compliance, must ensure that sales of hedge funds and funds of hedge funds comply

4.2 Dealing with conflicts of interests

The rules regarding the management of conflict of interest are relevant in the distribution of financial products, especially when these products are issued by the distributor or by entities belonging to the same group. Without proper management of conflicts, an intermediary may be incentivised to sell unsuitable products in order to generate revenue.

The conflict of interest rules usually do not target specifically the sale of complex products, but are – again – those generally applicable to any financial product. In the **US** and **IT**, however, there are special guidelines for certain types of complex products, i.e. respectively, new financial products and illiquid financial products.

The requirements for the management of conflict of interest dealt with by the general regulation usually include requirements to mitigate conflicts through specified actions or to disclose the conflict. For example, regulation may provide that the intermediary shall:

- maintain and operate effective organizational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the interests of their clients[100];
- develop systems for identifying transactions with the risk of conflict of interest methods of conflict of interest management, formulate the conflict of interest management policy and publish its summary[101];
- disclose in writing any actual or potential conflict of interest arising from any connection to or association with any product provider, including any material information or facts that may compromise the intermediary's objectivity or independence in its provision of financial advisory services, as well as all remuneration, including any commission, fee and other benefits that it receives that is directly related to the marketing of any investment to clients[102];
- disclose material conflicts of interest[103].

In **HK** an intermediary should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its clients are fairly treated. In addition, where the intermediary has a material interest in a transaction with or for a client or a relationship which gives rise to

with all relevant NASD and SEC rules including the appropriateness of the suitability determinations made by their associated persons. See NASD Notice to Members 03-07 (Feb. 2003).

100 This is the case in the **EU** where it is specified that an investment firm shall take all reasonable steps to identify conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof. Where organizational or administrative arrangements are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the intermediary shall clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf. In **AU** intermediaries are required to have adequate arrangements for the management of conflicts of interest. ASIC provided general guidance on controlling and avoiding conflict of interest as well as on disclosing them to retail clients.

101 This is the case in **JP**.

102 This is the case in **SG**.

103 This is the case in the **US**.

an actual or potential conflict of interest in relation to the transaction, it should neither advice, nor deal in relation to the transaction, unless it has disclosed that material interest or conflict to the client and has taken all reasonable steps to ensure fair treatment of the client. Further, intermediaries must not take commission rebates or other benefits to be received by them or their related companies as the primary basis for recommending particular investment products to clients. Where intermediaries only recommend investment products which are issued by their related companies, they should disclose this limited availability of products to each client.

In the **US,** broker-dealers also are required, under certain circumstances, such as when making a recommendation, to disclose material conflicts of interest to their customers, in some cases at the time of the completion of the transaction[104]. Additionally, federal securities laws and FINRA rules restrict broker-dealers from participating in certain transactions that may present particularly acute potential conflicts of interest[105].

In **IT**, in the recommendations on the distribution of illiquid products, Consob provided that intermediaries should put in place adequate internal arrangements and procedures ensuring an easy and proper identification of the pricing conditions applied to the client, including the parameters and mark-up applied to any executed transactions.

5. Distribution to the client…

5.1 When the client fails to provide information

SC3 members have adopted different rules concerning the consequences arising from a failure by the client to provide the required information. The main approaches can be summarized as follows:

- intermediaries are prevented from providing the relevant service[106];
- intermediaries may refuse to enter into the transaction with the client[107];
- intermediaries must restrict the account to liquidating trades only until completed application is approved[108];
- intermediaries must issue a warning to the client (under EU appropriateness requirements for non-advised transactions)[109];
- intermediaries shall explain to the client the inherent limitations of the advice as a result of the lack of information and the assumptions it made in relation to the advice

104 For example, broker-dealers must disclose acting as a market maker for the recommended security, trading as principal with respect to the recommended security, and if there is a revenue sharing arrangement with a recommended mutual fund.

105 For example, SEC Regulation M prohibits certain activities for persons with an interest in a public offering and FINRA Rule 5121 precludes a member from participating in a public offering if there is a conflict of interest.

106 In **BR**, **DE**, **ES**, **FR**, **IT**, **NL**, **UK**.

107 In **JP.**

108 In **CA.**

109 In **AU**, **DE**, **ES**, **FR**, **IT**, **NL**, **SG**, **UK. AU** and **UK** clarify that the warning provided to the client does not relieve the intermediary from the obligation to make reasonable inquiries.

given[110];

- intermediaries must ask the client to sign a letter confirmation whereby he/she acknowledges the risks of the product[111].

In **EU** jurisdictions[112], the approach adopted is different depending on the type of service provided. When providing investment advice or portfolio management, the investment firms are prevented from making a personal recommendation to the client, or taking a decision to trade for him. When providing an investment services other than investment advice and portfolio management, investment firms must provide a warning to the client if the client fails to provide adequate information to allow the firm to determine appropriateness.

In **BR**, the CVM new proposed rule requires that intermediaries have all necessary customer information prior to the execution of any transaction. Therefore in practice, if a customer does not provide requested information, the intermediary is for all practical purpose prohibited from offering or recommending an investment product to the customer.

In the **US**, there is an obligation for all FINRA members to use reasonable diligence to know the relevant facts about their customers in order to comply with all rules and regulations[113]. Additionally, the refusal of a customer to provide information pursuant to FINRA Rules 2352 (for warrants), 2360 (for options) or 2370 (for securities futures) must be noted on the customer's records at the time the account is opened. Information provided shall be considered together with the other information available in determining whether and to what extent to approve the account for warrants, options, or securities future trading, as applicable. Broker-dealers should consider obtaining similar information before allowing purchases of some or all structured products.

5.2 …where the product is unsuitable (q. 15)

In many jurisdictions[114], an intermediary cannot sell or recommend financial services and products to a client if it has assessed that the services or products are unsuitable for that client. In other jurisdictions, intermediaries are allowed to carry out the unsuitable transaction if the customer so requests and the intermediary has not recommended the transaction[115].

In particular, in the **EU** the rule preventing intermediaries from recommending or executing the transaction applies without exceptions, even if the client would instruct otherwise, when intermediaries provide investment advice and portfolio management. Conversely, for investment services other than those mentioned above, intermediaries may provide the

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110 In **HK** and **CH.**

111 In **MX.**

112 **DE**, **ES**, **FR**, **IT**, **NL** and **UK.**

113 FINRA Rule 2090.

114 This is the case in **AU** (in relation to certain products, i.e. margin lending facilities—assuming that this comment refers to suitability obligations across the whole range of financial products and not just complex products), **BR**, **DE**, **ES**, **FR**, **IT**, **NL**, **UK**.

115 This is generally the case in **BR**, **CA, MX, SG, CH** and the **US**. It should be noted, however, that in the U.S., FINRA has taken the position that in some cases it is even inappropriate for a broker-dealer to execute unsolicited (i.e., not recommended) unsuitable transactions for retail investors.

service to the client (but are not obliged to do so) after having warned the client that the product is not appropriate for him. This is the consequence of the fact that in the EU a narrower regime (appropriateness) applies to services other than investment advice and portfolio management[116].

In other member systems the prohibition applies unless the client instructs the intermediary to carry out the transaction, notwithstanding it is unsuitable[117]. In **US**, for instance, if the customer requests to purchase a complex financial product that is not suitable to that customer (on an unsolicited basis), the broker-dealer may proceed with the customer's request. However, with respect to index warrants, currency index warrants, and currency warrants, options and securities futures the broker-dealer must also approve the customer for such trading before opening an account and a comparable procedure should also be followed before approving an account to trade structured products.

In **JP**, the refusal of the intermediary to enter into transaction with the customer is discretionary. The intermediary may decide to refuse even when it received an acknowledgment letter from said customer confirming that there is no solicitation or advice.

In **SG** and **CH** the intermediary is not prohibited from carrying out the transaction and is allowed to proceed with the client's request to purchase after the client has been warned/informed. In **SG**, if a client declines to provide information necessary for an intermediary to make a suitability assessment, or declines to accept the intermediary's assessment that a product is unsuitable, the intermediary may seek senior management's approval to proceed with the client's request, and document the decision of the client.

In **HK**, the intermediary is required to act in the best interests of the client. In **MX** the sole obligation for intermediaries is to contact the client to explain the situation.

5.3. …disclaimers by intermediaries

For all members, generally an intermediary is not permitted to disclaim its responsibility to customers with regards to suitability, including in connection with complex financial products. Nonetheless, as mentioned, the suitability obligations may not apply to non-retail customers and/or to non-advisory services. For example, in the **US**, intermediaries are not permitted to disclaim any responsibilities that arise under suitability rules[118]. Generally, a US broker-dealer fulfils its suitability obligation to determine that a recommendation is suitable for an institutional customer if the broker-dealer has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of

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[116] In **UK**, if a client rejects a recommended approach and insists on an unsuitable transaction, a firm would be expected to consider whether it is willing to proceed on a non-advised basis in the circumstances of the case. In **NL**, an intermediary is allowed to carry out an execution only request to purchase an unsuitable product, if the customer signs that he does not accept the negative advice from the intermediary and wishes to purchase the product irrespective of this advice.

[117] This is the case in **CA** and **US.** In **CA** it is common practice for a firm to ask a client requesting to place a transaction that would not be suitable for written instruction before to proceed. The firm can refuse to place the transaction, even if the customer volunteers written instructions, and in case it decides to proceed the transaction is to be marked as unsolicited.

[118] FINRA Regulatory Notice 11-02 (Jan. 2011).

evaluating investment risk[119].

In some jurisdictions the intermediary can execute the transaction after having obtained written consent acknowledging that the security is not suitable for him/her[120].

6. Disclosure obligations

In all responding member jurisdictions, disclosure requirements are meant to ensure that customers and potential customers are reasonably able to make the investment decision on an informed basis. Therefore, information addressed to them must be material, fair, clear and not misleading. Several members require that when dealing with retail investors intermediaries employ simplified and user-friendly format summarizing the key features of the complex financial product. These formats also facilitate comparison of information across different types of products.

In virtually all member jurisdictions, investors in complex financial products are required to have access to, or be provided with, information before or at the point of sale concerning:

(a) the material risks and characteristics associated with investment in the financial product or in respect to a particular investment strategy;

(b) the costs of the product;

(c) the duration and liquidity of the product; and

(d) the conflicts associated with the intermediary selling the product (including the intermediary's remuneration).

Whilst in some countries the duty to provide information rests on the intermediaries, in other countries disclosure obligations are shared between intermediaries and issuers. In particular, in the **US** issuers must provide product specific information for registered securities in their offering materials.

Also, the scope and level of details of such disclosure requirements vary from member to member. For instance, in some jurisdictions, such as **FR**, **IT**, **JP**, **SG**, and **US** intermediaries have to disclose certain additional information in connection with certain complex financial products, in order to enable customers to understand their specific nature and risks. In **FR**, the regulator considers that some products are too complex to be sold to retail investors; in these cases the relevant marketing documents must include a warning to this effect[121]. To prevent the risk of mis-selling of *structured* investment funds and complex debt securities, the French regulator has published a position (October 2010) explaining how it interprets existing laws and regulations governing direct marketing of complex final instruments[122].

[119] FINRA Rule 2111(b).

[120] This is the case in **CA** (the transaction would be marked as unsolicited) and **MX**.

[121] The warning reads: "the AMF considers this product to be too complex to be marketed to retail investors and has not therefore examined the marketing documents".

[122] There are four criteria to determine whether the products to be marketed are likely to cause investors to underestimate the risks involved or even to misunderstand the product, which are: (i) poor presentation

In some jurisdictions, disclosure obligations are generally tailored to the type of customer (*e.g.,* retail vs. non-retail investors) and the service provided.[123] In such jurisdictions, the requirements applicable towards retail customers are generally stricter. Similarly, the provision of advisory or discretionary services, including portfolio management, may entail application of more comprehensive disclosure requirements.

7. Enforcement

7.1 Supervisory responsibility by competent authorities

In most of the jurisdictions the responsibility for monitoring and enforcing compliance with suitability requirements relating to complex financial products is assigned exclusively to the relevant national securities regulators[124].

In **CH**, some tasks of monitoring can be delegated to auditors or specific agents; however, enforcement and sanctioning authority always remain with FINMA.

In one jurisdiction, SROs are solely responsible for the supervision and enforcement of suitability requirements (**BR**: ANBIMA). In this regard, it should be noted that in **BR** a new rule has been proposed, which provides that the CVM (the national regulator) will become responsible for monitoring and enforcing compliance with suitability requirements.

In the remaining jurisdictions, the responsibility is shared between the national regulators SROs. In the **US,** the responsibility is also shared with State securities regulators[125].

The main measures employed by the above- mentioned regulators and self-regulators are on-site and off-site inspections, thematic reviews and sweeps, monitoring and analyzing information from the intermediaries and reviewing investors' complaints.

Regulators typically may initiate either administrative and/or civil court proceedings for violation of suitability obligations. SROs may also be able to initiate administrative proceedings.

7.2 Remedies available to customers

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of the risks or potential losses, especially when the product's performance is sensitive to extreme scenarios; (ii) underlyings that are hard to identify or impossible to observe individually on the markets; (iii) gains or losses that depend on the simultaneous occurrence of several conditions across different asset classes; (iv) multiple mechanisms incorporated into the formula used to compute gains or losses at maturity.

[123] In the U.S., registered offerings have a single standard of disclosure. No distinctions are made between retail and non-retail customers.

[124] In **AU**: ASIC; in **CH**: FINMA; in **DE**: Bafin; in **ES**: CNMV; in **FR**: AMF; in **HK**: SFC and HKMA (this latter for banks); in **IT**: Consob; in **NL**: AFM; in **UK**: FSA and in **SG**: MAS). The other main regulatory body in **UK** with a role is the Financial Ombudsman Service (considering complaints).

[125] In **CA**: all Provincial Securities Commissions and the national SRO (IIROC); in **JP**: JFSA, Securities and Exchange Surveillance Commission and Japan Securities Dealers Association; in **MX**: CNBV and AMIB; in **US**: SEC, FINRA, and state regulators such as the New York Attorney General's Investment Protection Bureau.

In most jurisdictions, if an intermediary has violated suitability requirements, the relevant customer can bring a case before a civil court for contractual damages. In some jurisdictions, however, such as the US, investors more typically will seek redress through arbitration rather than before a civil court.

In many legal systems, intermediaries must also set up internal procedures for handling complaints[126]. Customers may submit written complaints through these systems and seek explanations and/or compensation. In case the client is not satisfied or otherwise the parties do not agree, the client may be able to refer the matter to an arbitration court or an Ombudsman for banking services and investments.

Investors may usually file complaints also with the regulatory authority, which will analyze the issue and/or take action where appropriate[127]. Some regulators have also set up a mediation department competent in helping the parties to achieve a settlement of their dispute[128].

In the **US,** disputes between the customer and the broker-dealers are usually arbitrated or mediated[129]. FINRA's arbitration forum administers the majority of cases between broker-dealers and their customers and administers over 90 percent of all securities arbitrations in the US[130]. FINRA also offers a mediation program providing an informal, voluntary, and non-binding approach to dispute resolution in which an independent and trained neutral mediator facilitates negotiations between disputing parties, helping them find a mutually acceptable resolution. Moreover, the SEC has authority to return ill-gotten gains to injured investors by allowing civil penalties to be included in such distributions, through what is known as a "Fair Fund."[131]

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126 This is the case in **CA, EU, SG**.

127 This is the case in CA, ES, HK, IT, FR, JP, CH.

128 In **CA, FR, IT, JP**. In **CA**, dealer members are required to participate in the arbitration proceedings, should the client initiate them.

129 SRO rules require SRO members to arbitrate any eligible dispute submitted by a customer. Customers are not, however, required by SRO rules to arbitrate these disputes. Rather, customers generally agree to arbitrate these disputes in the contracts they sign when they open brokerage accounts. If customers do not agree to arbitrate their disputes, they can bring a legal action in court against the broker-dealer.

130 FINRA has a network of 73 hearing locations across the **US** and in other countries and maintains a roster of approximately 6,500 arbitrators. In 2010, a total of 5,680 cases were filed with FINRA's arbitration forum; 6,241 cases were closed.

131 Since 2002, the SEC has distributed $4.6 billion to victims of fraud and other securities law abuses. Whether the SEC establishes a "Fair Fund" in a case generally depends on the amount it can recover, the number of harmed investors, and the ability to identify them.

Chapter 2 — Lessons Learned from the Crisis And Actions Undertaken

1. Mis-selling of complex products during the crisis

Some members noted that during the crisis the number of disputes between the customers and the intermediaries sharply increased as a result of the harsh economic conditions and the collapse of Lehman Brothers[132]. In some cases, investors complained that complex products were sold as replacement for fixed income investments or *cash equivalents* such as certificates of deposit, treasury, money markets and saving accounts, or as alternative to deposit-based products offered on the banking side. Complex products were often sold to elderly and senior investors with little investing experience and market knowledge.

In **AS**, it emerged that some problems were due to inappropriate advice and standards of service where over-enthusiastic sales techniques saw sellers giving personal advice without completing the necessary suitability assessments. A number of disputes also showed a lack of consumer understanding of the operation of sophisticated derivative products, such as contracts for difference. Often these products were sold on an *execution-only* basis, without protection for the investors[133].

In **HK** there was a significant number of complaints received by the regulators regarding Lehman products and their alleged mis-selling to retail investors. The SFC and the HKMA investigated the complaints and also reviewed the existing regulatory requirements. The SFC's review indicated that while the existing requirements were adequate it nonetheless considered that the selling practices of intermediaries could be further enhanced, and amended the related regulations in May 2010 accordingly.

In **SG** the authorities noticed various failures to comply with the regulatory notices and guidelines on the sale and marketing of investment products.

In **DE** and **ES**, many investors suffered financial losses due to the fact that they held structured products issued by Lehman entities.

In **MX** and in **IT**, it is noted that one of the main factor contributing to the mis-selling of complex financial products was the remuneration structures of the persons involved, since the commissions were well above traditional or plain vanilla instruments. Moreover, during the crisis it became difficult for intermediaries to achieve profit objectives and this incentivized the selling of complex products.

In **IT**, Consob released regulatory guidance on the distribution of complex product where it is noted that certain complex financial products are often perceived by investors as bearing little or no downside risks, especially in the case of debts (including structured notes) issued or backed by banks and financial insurance products. Distributors, in turn, may be tempted to sell these products to their client, even when they are not in line with the risk profile or expertise of the investor, in order to benefit from the high upfront commissions (around 5-8% of the face value). The current crisis provided incentives to the mis-selling of products issued

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[132] This is mentioned by members from **AU, DE, ES, HK, IT, JP** (where the increase of complaints mainly relate non-public or illiquid stocks) , **MX, SG, UK, US**.

[133] These data are based on the review of disputes for 2008-2009 by the Financial Services Ombudsman.

by entity belonging to the same group of the distributor, since the alternative sources of financing are eroded: banks may be tempted to stabilize their funding and reduce relevant costs by distributing own illiquid financial products to retailers.

In the **UK**, the FSA carried out a review of the sale of structured investment products backed by Lehman Brothers, showing that significant levels of unsuitable advice and systems and controls failings occurred. The findings were published on 27 October 2009, together with recommended actions for firms (all available on the FSA web site). The UK Financial Ombudsman Service also reported that it had received a number of complaints about structured products backed by LB.

In the **US,** it was noted that, increasingly over the few years before the financial crisis began in 2007, many bank-affiliated broker-dealer firms sold complex products to their own depositors to raise funds and gather more assets under management. Separately, with regard to all broker-dealers, customers also did not understand the many technical features of the products they purchased, such as for instance how interest accrues and relevant returns. Many brokers apparently did not have an adequate understanding of the product features themselves.

US regulators also have emphasized the role that complex products can sometimes play in increasing systemic risk. In testimony to Congress, the CFTC Chairman Gensler discussed the fact that the 2008 financial crisis was caused in part by the lack of regulation of OTC derivatives products. For example, one firm alone – AIG – was provided with over $180 billion in US government assistance[134] in order to prevent *cascading losses* thoughout the financial system. Federal Reserve Chairman Bernanke informed the Financial Crisis Inquiry Commission (FCIC) established after the 2008 crisis, that of the 13 most important US financial institutions, only one was *not* at serious risk of failure within a period of a week or two during the crisis.[135]

While the FCIC identified multiple failures that led to the financial crisis, the Commission highlighted OTC derivatives market as a key element that increased systemic risk and resulted in a web of financial firm *interconnections* that forced the US Government to bail out financial institutions with major positions in the OTC markets:

"Enormous positions concentrated in the hands of systemically significant institutions that were major OTC derivatives dealers added to uncertainty in the market. . . . . A series of actions, inactions, and misjudgments left the country with stark and painful alternatives -- either risk the total collapse of our financial system or spend trillions of taxpayer dollars to stabilize the system and prevent catastrophic damage to the economy. In the process, the government rescued a number of financial institutions deemed "too big to fail" – so large and interconnected with other financial institutions or so important in one or more financial markets that their failure would have caused losses and failures to spread to other institutions. . . . .[136]"

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[134] FCIC Report at 379. Subsequent sales of AIG assets ultimately reduced the net cost of the US government bailout of the firm.

[135] FCIC Report at 354.

[136] FCIC Report at 386.

As a result of the widespread recognition that OTC derivatives had been a significant contributor of the financial crisis, a series of policy initiatives were undertaken to better regulate the financial markets, both at a global as well as through legislation in the United States. The US requirements applicable to suitability for swaps and security-based swaps are described below.

In **JP**, although general complaints increased, complaints regarding complex financial products remained basically unchanged. Moreover, there was no clear trend on the increase of mis-selling of complex financial products.

2. Supervisory actions taken

Following the number of investors' complaints, the large majority of respondents took actions to strengthen the monitoring of compliance with suitability requirements.

The main supervisory initiatives undertaken are examination reviews and thematic inspections, whereby members reviewed the internal organization and the business conduct of licensed distributors. In some cases, the investigations are still ongoing. In others they led to the issue of sanctions. For instance, in **ES**, as a consequence of the results of on-site inspections, firms were required to change procedures, internal processes and of sanctions have been proposed. Similarly, in **HK**, the SFC and the HKMA have introduced a number of regulatory requirements to enhance the selling practices of the intermediaries[137].

In **AU**, ASIC has developed a forward program focusing on: (a) improving the quality of advice by increased surveillance and (subject to consultation) raising the training standards for financial advisers; (b) improving the effectiveness of disclosure e.g. by introducing disclosure against benchmarks for specific products on an *if not, why not* basis; and (c) improving financial literacy and retail investor education[138].

In **CA,** IIROC conducted two compliance sweeps: one specific to the ABCPs and a second one on new products due diligence. Both sweeps were followed by a report outlining the general findings and recommendations.

In **DE,** as a reaction to the Lehman insolvency, BaFin performed special audits at the credit institutions which had foremost distributed these products (thematic work).

In **FR**, the AMF has put in place a new strategic plan that includes a strong focus on the control of the way complex products as well as other financial products are sold to clients. In this context:

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[137] In **HK**, a review of regulatory regime of selling practice was conducted by the SFC through a public consultation and a set of Consultation Conclusions was issued in May 2010. The enhanced requirements include disclosure of benefits received by intermediaries for distribution of investment products, restricting the use of gifts in promoting a specific investment product, and assessing a client's knowledge of derivatives and taking certain steps where the client is characterized as without knowledge of derivatives and the intermediary has not made any solicitation or recommendation.

[138] Further detail on these initiatives is outlined in ASIC's submission to the Parliamentary Joint Committee Inquiry into Financial Products and Services in Australia. A copy of this submission is available via: http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub378.pdf

- in order to deliver heightened risk monitoring and closer supervision of market participants, new tools for monitoring and controlling the whole distribution or marketing chain have been developed in order to monitor sales campaigns, issue investor alerts, increase the number of controls at the point of sale, and introduce mystery shopping. These actions are coordinated with the insurance and banking supervisors;

- in order to enhance investor protection and bolster the confidence of individual investors, a new division in charge of relations with individual investors was created in 2010. That division now covers all AMF actions aimed at individual investors (mediation, education and consultation) and the activity of a special committee dedicated to monitoring trends in new practices and products.

In **JP**, in the Annual Supervisory Policy for Program Year 2009 and 2010, the FSA has encouraged the operators to improve customer protection and convenience for users. The subprime loan crisis has revealed the global extent of focuses of the securitized instruments market and its attendant risk management issues. One of the focuses on inspections to securities firm was thus on the securitization process, namely underwriting examination, risk management, sales management and other related control systems of financial firms that arrange, underwrite, and market such securitized instruments.

In **MX** a new department was created in the Commission that is currently monitoring the selling practices by financial advisors.

In **SG**, on 7 July 2009, MAS issued a press statement announcing the actions taken against the intermediaries as a result of its investigation findings of the sale and marketing of structured notes linked to Lehman Brothers. MAS imposed bans on the sale of structured notes by the intermediaries who have sold structured notes linked to Lehman Brothers for periods ranging from six months to two years. In addition, MAS has issued formal directions to the financial institutions to rectify all the weaknesses identified by the investigations and to review and strengthen all internal processes and procedures for the provision of financial advisory services across all investment products. The financial institutions were also required to appoint an external person approved by MAS to review their action plan and report on its implementation, and appoint a member of the institution's senior management to oversee compliance with MAS' direction.[139]

In the **UK**, (as noted above) the FSA's review of Lehman Brothers backed structured products included assessments of the suitability of advice given to invest in these products. As a result, the FSA is taking action with a number of firms, including past business reviews and formal enforcement cases[140]. All relevant customers are being encouraged to seek

[139] More information regarding the actions taken is available at the following link: http://www.mas.gov.sg/news_room/press_releases/2009/MAS_Releases_Investigation_Findings_on_the_Sale_and_Marketing_of_Structured_Notes_Linked_to_Lehman_Brothers.html

[140] See *Quality of advice on structured investment products - The findings of a review of advice given to consumers to invest in structured investment products backed by Lehman Brothers from November 2007 to August 2008*, Financial Services Authority, 27 October 2009, available at http://www.fsa.gov.uk/pubs/other/qa_structured.pdf.

Further details are provided in report publishing the findings of the FSA's investigation of 27 October 2009, available at the FSA web-site.

redress as appropriate. They have also published a template outlining their methodology in assessing the quality of advice for this product type under their rules, and expect firms to use it when assessing any complaints that they receive.

In the **US**, FINRA has focused its examination authority on the sale of complex financial products and has imposed disciplinary measures against members for suitability and other concerns related to their sale. From an examination and investigation perspective, FINRA's sales practice concerns address a wide variety of complex products including mortgage backed securities, asset backed securities, municipal securities, real estate related products, variable annuities, and structured products. Regarding structured products, their number and type have been increasing along with their complexity. FINRA's review of structured products has identified sales practice concerns in Inverse and Leveraged ETFs, ETNs, reverse convertibles, and principal protected notes. Reflecting the importance FINRA attaches to this area generally, FINRA included high yield and non-conventional products among its examination priorities for 2011.[141] Currently, given the present yield-chasing market environment, FINRA is conducting a sweep of spread based structured products.

Where necessary and appropriate, FINRA has proceeded to take enforcement actions. In these actions, FINRA has found problems with broker-dealer transactions in complex products as they pertain to due diligence and understanding of the product, training of the sales force, marketing, risk disclosures, reasonable basis and customer specific suitability (suitability violations have included inappropriate concentration levels of these complex and risky products), and supervision.[142]

3. New regulation passed or under discussion

After the crisis several jurisdictions started to review the rule applicable to the sale of complex financial products. Regulators focused on strengthening of the internal controls in the distribution of complex products, including compliance policies, training and proper incentive and remuneration of personnel, as well as to clarify the standards for the product and customer due diligence, in order to ensure that the intermediary adequately considers the special features of the complex products that it is selling. In some jurisdictions the process of revision is not yet finalized.

This is the case, for instance, in **EU**, where the Commission has proposed amendments to MiFID in order to address issues that have emerged after its initial implementation, including

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[141] See FINRA Letter to Chief Compliance Officer, February 8, 2011, available at http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p122863.pdf.

[142] The following links provide detail about recent significant enforcement actions**:** (1) *FINRA Fines Santander Securities $2 Million for Deficiencies in Its Structured Product Business and Unsuitable Reverse Convertible Sales*, http://www.finra.org/Newsroom/NewsReleases/2011/P123491; (2) *FINRA Fines UBS Financial Services $2.5 Million; Orders UBS to Pay Restitution of $8.25 Million for Omissions That Effectively Misled Investors in Sales of Lehman-Issued 100% Principal-Protection Notes*, http://www.finra.org/Newsroom/NewsReleases/2011/P123479; and (3) *FINRA Orders Ferris, Baker Watts to Pay Nearly $700,000 for Inappropriate Sales of Reverse Convertible Notes*, http://www.finra.org/Newsroom/NewsReleases/2010/P122291. In addition to these significant regulatory actions, FINRA has also initiated a new program to gather timely information on firms' new product offerings and oversight programs through ongoing surveys of the industry. Analysis of information from these surveys and from other sources is provided to support various FINRA efforts, including development of regulatory guidance, enhancing examination programs, and staff training.

lessons learned from the crisis. The proposals touch upon the suitability and appropriateness rules. On this topic, CESR published a report evidencing that MiFID requirements on appropriateness for non-advised transactions could be clarified in respect to their application to a number of types of complex products, including structured investment products. The EU is also considering possible new legislation covering *Packaged Retail Investment Products* not covered by MiFID, aiming to standardize selling practices for instruments such as structured products set up as insurance products.

In **AU**, the focus has been on the retail investor sector where retail investors have suffered in a stream of business collapses and failed investment products. The primary causes of these collapses and corporate failures were the market downturn and flawed business models, that is, business models that could only prosper if asset prices continually rose and debt markets remained open and liquid. In Australia there is no regulatory intervention on the design and availability of financial products for retail distribution. The debate in Australia is focused on whether the Australian regulatory system should continue to allow risky financial products to be sold to retail investors on the basis that disclosure is an adequate tool to ameliorate the risk of harm to them.

In **BR**, CVM decided to publish a new proposed rule, that addresses the requirements applicable to advisory and non-advisory services, the policies for dealing with complex products and the organizational requirements, which includes the designation of an officer in charge of the suitability procedures and controls.

In **MX**, the CNBV is envisaging to change current regulation in order to require that only persons who have the necessary knowledge and experience can buy complex financial products. CNBV is also considering incorporating requirements related to the transparency and determination of incentives paid to persons involved with the structuring and selling of securities including complex financial products.

In **CH**, FINMA's strategic goals for 2010 – 2012[143] contain, inter alia, the improving of clients' protection. FINMA will promote appropriate due diligence, disclosure and information requirements at the point of sale, with an emphasis on shedding clarity on products' risk profiles (earnings opportunities and risks of loss). FINMA will also examine distribution regulations on a cross-sector basis, including the supervisory regulations applying to intermediaries and the demarcation between qualified investors and small clients. FINMA's goals will form the basis for concrete initiatives and projects which are due to be implemented in the next three years.

In the **US**, to the extent that the size or financial condition of an investor is not an adequate surrogate for sophistication, the SEC, FINRA or both, could consider developing new standards. In particular, consideration may be given to whether designations that equate size with sophistication should be further refined in the context of complex financial products and differing levels of sophistication of investors. Nonetheless, those with responsibility for the financial well-being of others, including a broad array of financial institutions, should be required to adhere to minimum standards of expertise and diligence. FINRA has adopted a

[143] See *FINMA defines its strategic goals*, Press Release, 30 September 2009, available at http://www.finma.ch/e/aktuell/pages/mm-strategie-finma-20090930.aspx. The strategic goals have been approved by the Federal Council. In so doing, the Federal Council has declared its support for FINMA's strategic positioning.

new suitability rule that becomes effective on July 9, 2012[144]. The rule requires a member to complete reasonable diligence on the products they recommend "depending on, among other things, the complexity of and risks associated with the security or investment strategy and the broker's familiarity with the security or investment strategy."[145] The new suitability rule, moreover, includes an expanded list of customer information that a broker must attempt to learn, such as the customer's investment experience, investment time horizon, liquidity needs, and risk tolerance[146].

As mentioned, several members already issued new regulation or recommendations in matters of suitability assessment in relation to complex financial products.

Indeed, in **CA**, IIROC recently issued guidelines on product due diligence.

In **DE**, BaFin has drafted guidelines on the duties and position of the compliance function of credit institutions and investment firms in order to strengthen the position of the compliance function vis-à-vis the management of the firms. The strengthening of the compliance function aims at a more effective control of the activities of the sales and distribution division of the firms by the compliance function. New legislation on the documentation of the provision of investment advice opposite a private client has been passed in Germany. Starting January 1st, 2010, all investment advisors are required to provide protocols of discussions with private clients. This is aimed at providing BaFin with a clearer picture of the course of such a session in order to better assess whether the regulatory provisions including the suitability requirements have been fulfilled by the advisor.

In **HK**, the SFC has reviewed its regulatory regime on selling of investment products. A set of requirements were introduced to enhance the selling practices and conduct of intermediaries in May 2010. Among the requirements, an intermediary is not allowed to use gifts to promote a specific investment product to clients, it is required to disclose to clients at the pre-sale stage the benefits received for distribution of investment products, and to characterize whether a client has derivative knowledge. Where a client without knowledge of derivatives wishes to purchase a derivative product and the intermediary has not solicited or provided a recommendation to the client, the intermediary should (a) explain the risks associated with the product to the client if the product is an exchange-traded product; or (b)

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[144] FINRA Rule 2111 will replace NASD Rule 2310, which required brokers to consider, *inter alia*, the complexity of and risks associated with all recommended securities. Case law interpreting the NASD rule, for instance, has held, among other things, that brokers must understand the securities they recommend and must be satisfied that their customers understand the risks involved and are able to take those risks.

[145] See *Know Your Customer and Suitability,* FINRA Regulatory Notice 11-02, Jan. 2011, available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf.

[146] FINRA also has occasionally created rules with suitability components that focus on specific investment products or strategies that are particularly complex or risky, such as the rules covering options, futures, deferred variable annuities, and day trading. In addition, FINRA has issued regulatory notices reminding brokers of their suitability obligations when they recommend certain other types of complex or risky products or strategies. For example, FINRA has issued notices regarding hedge funds, variable life settlements, liquefied home equity, illiquid investments, leveraged and inverse exchange-traded funds, and non-conventional investments. Based on both a careful review of the effectiveness of existing rules and regulatory notices over the recent past and a watchful eye for trends indicating the possible need for additional protections for investors, FINRA will continue to evaluate whether new rules or notices should be developed.

warn the client about the transaction and provide appropriate advice to the client as to whether or not the transaction is suitable for the client in all the circumstances if the product is a non-exchange traded product.

In **IT**, Consob developed guidance on suitability requirements in the distribution of illiquid products to retail clients[147]. Moreover, Consob officially confirmed industry guidance developed following this Communication.

In **JP**, the FSA revised the guideline to ensure the traceability of underlying assets of securitization products in April 2008. In addition, the JSDA working group on distribution of securitized products established "Regulations Concerning Distributions, etc. of Securitized Products", which are SRO rules concerning disclosure of content of underlying assets and related risk, in June 2009. The FSA in April 2010 also revised the guideline to ensure that the operators explain the risks when they conduct OTC derivative transactions of currency options or interest rate swaps, etc. Furthermore, in April 2011, the FSA introduced a ban on unsolicited offers for OTC derivative transactions to retail investors to further strengthen investor protection.

In **SG**, MAS introduced new requirements for intermediaries to formally assess a retail customer's investment knowledge and experience before selling specified investment products to the customer. Under the new measures, effective from 1 January 2012, intermediaries must assess whether a customer understands the risks and features of complex structures or derivatives, before allowing the customer to trade or purchase such products. MAS does not allow *execution only* service for customers who do not possess the relevant knowledge or experience.

In **ES**, CNMV has published guidance and best practices about the assessment of the suitability and appropriateness regarding the provision of investment services to retail clients.

In the **UK**, the FSA published the templates and other materials it used to assess suitability, to help advisers understand the type of issues that they should consider when advising on structured products.

In the **US**, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which amends the Commodity Exchange Act (CEA) and the Securities Exchange Act of 1934 (Exchange Act) to establish a comprehensive new regulatory framework for swaps and certain security-based swaps. The legislation was enacted to reduce risk, increase transparency, and promote market integrity within the financial system.

Sections 731 and 764 of the Dodd-Frank Act amend the CEA and Exchange Act to provide the CFTC and SEC with rulemaking authority to impose business conduct standards for swap dealers and major swap participants (SDs/MSPs) and security-based swap dealers and major security-based swap participants (SBS Entities) dealing with counterparties generally and additional requirements for dealing with *Special Entities*, which include certain federal and state and municipal governmental entities, as well as certain non-governmental pension plans and endowments. The rules proposed under the CFTC and SEC rulemaking authority prohibit certain activities and impose duties on SDs /MSPs and SBS Entities in their dealings

147 See Consultation Paper of May 26, 2008 and Communication no. 9019104 of March 2, 2009.

with counterparties.

Among the requirements set forth in these proposed rules regarding business conduct with counterparties, a SD/MSP or SBS Entity must verify a counterparty's eligibility to transact in the swaps or security-based swaps markets; provide disclosure of the material risks (including, in certain cases, a *scenario analysis*) and characteristics of the swap or security-based swap; provide disclosures regarding any material incentives or conflicts of interest; provide a daily *mark* of the swaps or security-based swap; and communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith.

With respect to Special Entities, the proposed rules codify the statutory requirements under Dodd-Frank that the SD/MSP or SBS Entity entering into a swap or security-based swap with a Special Entity must have a reasonable basis to believe that such an Entity has a representative: with sufficient knowledge to evaluate the transaction and risks; is independent of the SD/MSP; is not subject to a statutory disqualification; undertakes a duty to act in the best interests of the Special Entity; makes appropriate and timely disclosures to the Special Entity; will provide representations to the Special Entity regarding fair pricing and the appropriateness of the swap or security-based swap.

The CFTC has also proposed additional rules relating to fraudulent, deceptive and manipulative acts or practices, confidential treatment of counterparty information and prohibitions on trading ahead and front running of counterparty swap transactions.

In addition, in the US, FINRA developed specific guidance designed to clarify its regulatory expectations regarding the suitability requirements for complex products. In particular, FINRA recommended to its members to ensure that they:

- Conduct adequate due diligence to understand the features of the product prior to recommending them to customers;
- Perform a reasonable-basis suitability analysis;
- Perform customer-specific suitability analysis in connection with any recommended transactions;
- Provide a balanced disclosure of both the risks and rewards associated with the particular product, especially when selling to retail investors;
- Implement appropriate internal controls;
- Train registered persons regarding the features, risks, and suitability of these products;
- Take a proactive approach to reviewing and improving their procedures for developing and vetting new products;
- Update their procedures to include clear, specific and practical guidelines for determining what constitutes a new product, ensure that the right questions are asked and answered before a new product is offered for sale, and, when appropriate, provide for post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution.

In January of 2007, five federal agencies, including the SEC, issued a statement on complex structured finance activities of financial institutions. The statement describes the types of internal controls and risk management procedures that should help financial institutions identify, manage, and address the heightened legal and reputational risks that may arise from

certain complex structured finance transactions. The SEC incorporated the elements of this policy statement in its examinations that cover this area, particularly in the risk management exams of large institutions.

Chapter 3 — Responses from Industry Associations

To inform the development of the draft suitability principles, SC3 sought input from a number of industry associations and other stakeholders, variously representing investors, intermediaries and product providers. This input was sought via a questionnaire to survey their views about the application of suitability requirements to complex products and to seek information about industry practice in different jurisdictions.

Responses were received from the following organizations:

- Association of Banks in Singapore;
- Associacao Brasileira das Entidades dos Mercadoes Financeiro e de Capitais (ANBIMA);
- Association Francaise de la Gestion Financiere;
- European Fund and Asset Management Association;
- Financial Planning Standards Board;
- Financial Services Consumer Panel (UK);
- Hong Kong Association of Banks;
- Institute of Financial Planners Hong Kong;
- Investment Management Association of Singapore;
- Japan Securities Dealers Association; and
- Securities Association of Singapore.

The Technical Committee Standing Committee on the Regulation of Market Intermediaries (TCSC3) is grateful to all those industry associations who responded to the questionnaire.

Industry association responses confirmed that all jurisdictions provided for classification of investors with different levels of regulatory protection applicable. While the classification systems differed in different jurisdictions, most respondents considered that a higher degree of protection was appropriate for *retail customers*. However, that does not mean that all non-*retail customers* were immune from instances of alleged mis-selling in relation to complex financial products, or that all "non-retail customers" should be treated the same.

There was a high degree of consensus amongst respondents about the role of the intermediary in terms of ensuring suitability. Industry associations emphasized that the concepts of know-your-client and suitability were key to the investment advisory process. Some respondents indicated that, in practical terms, conducting a suitability assessment was applicable irrespective of the type of customer or product in question.

From an investor perspective, the Financial Services Consumer Panel (UK) emphasized the importance of the availability of simplified advice, suitable products and the need for transparency in the sales and advice process, including full disclosure of costs, fees and charges.

In terms of the role of product providers in relation to suitability, some respondents commented that providers have a role to play in ensuring that disclosure information is adequate and products are appropriately designed. Other respondents noted that it was the adviser's responsibility to comply with suitability obligations. The scope of this project and the applicability of these principles focus on the distribution of complex financial products by

market intermediaries, including product providers that directly sell the complex financial products they produce.